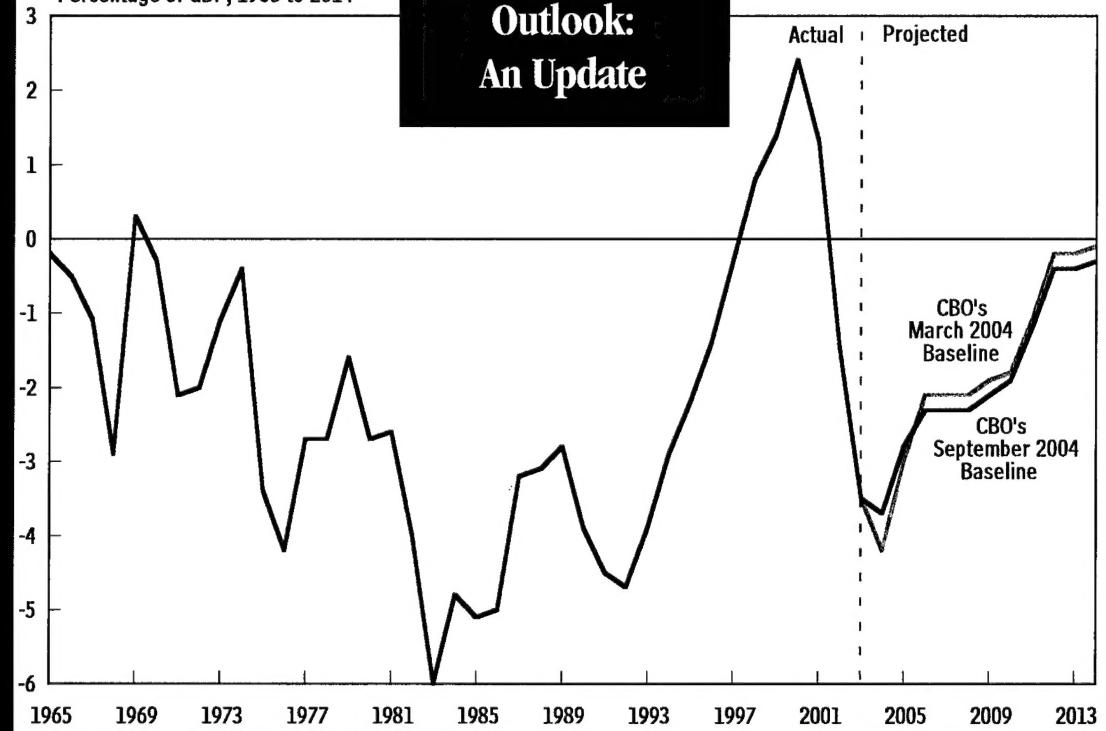


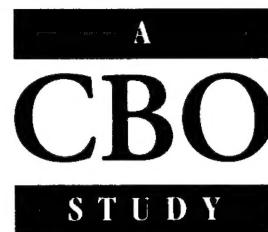
CBO

SEPTEMBER 2004

The Budget  
and Economic  
Outlook:  
An Update

Total Deficits and Surpluses as a  
Percentage of GDP, 1965 to 2014





# **The Budget and Economic Outlook: An Update**

September 2004

**A Report to the Senate and  
House Committees on the Budget**

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## Notes

Unless otherwise indicated, all years referred to in describing the economic outlook are calendar years; otherwise, the years are federal fiscal years (which run from October 1 to September 30).

Numbers in the text and tables may not add up to totals because of rounding.

Some of the figures in Chapter 2 use shaded vertical bars to indicate periods of recession. A recession extends from the peak of a business cycle to its trough.

Data for real (inflation-adjusted) gross domestic product are based on chained 2000 dollars.

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## Preface

**T**

his volume is one of a series of reports on the state of the budget and the economy that the Congressional Budget Office (CBO) issues each year. It satisfies the requirement of section 202(e) of the Congressional Budget Act of 1974 for CBO to submit to the Committees on the Budget periodic reports about fiscal policy and to provide baseline projections of the federal budget. In accordance with CBO's mandate to provide impartial analysis, the report makes no recommendations.

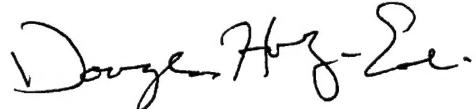
The baseline spending projections were prepared by the staff of CBO's Budget Analysis Division under the supervision of Robert Sunshine, Peter Fontaine, Janet Airis, Thomas Bradley, Kim Cawley, Paul Cullinan, Jeffrey Holland, and Jo Ann Vines. The revenue estimates were prepared by the staff of the Tax Analysis Division under the supervision of Thomas Woodward, Mark Booth, and David Weiner. The analysts who contributed to those spending and revenue projections are listed in Appendix D.

The economic outlook presented in Chapter 2 was prepared primarily by the Macroeconomic Analysis Division under the direction of Robert Dennis. John F. Peterson, Robert Arnold, and Christopher Williams carried out the economic forecast and projections. David Brauer, Ufuk Demiroglu, Tracy Foertsch, Douglas Hamilton, Juann Hung, Kim Kowalewski, Mark Lasky, Angelo Mascaro, Shinichi Nishiyama, Benjamin Page, Frank Russek, Robert Shackleton, and Sven Sinclair contributed to the analysis. Tumi Coker, Adam Gordon, Brian Mathis, and Amrita Palriwala provided research assistance.

CBO's Panel of Economic Advisers commented on an early version of the economic forecast underlying this report. Members of the panel are Andrew B. Abel, Alan Blinder, Dan Crippen, William C. Dudley, Martin Feldstein, Robert J. Gordon, Robert E. Hall, Robert Glenn Hubbard, Lawrence Katz, Catherine L. Mann, Allan H. Meltzer, Laurence H. Meyer, William D. Nordhaus, June E. O'Neill, Rudolph G. Penner, James Poterba, Robert Reischauer, and Alice Rivlin. James Burkhard, Minxin Pei, and Jone-Lin Wang attended the panel's meeting as guests. Although CBO's outside advisers provided considerable assistance, they are not responsible for the contents of this report.

Jeffrey Holland wrote the summary. The staff of the Projections Unit and Mark Booth wrote Chapter 1. Mark Lasky was the lead author for Chapter 2. Gerard Trimarco wrote Appendix A, and Barry Blom and Frank Russek wrote Appendix B.

Christine Bogusz, Leah Mazade, John Skeen, and Christian Spoor edited the report. Marion Curry, Linda Lewis Harris, and Denise Jordan-Williams assisted in its preparation. Maureen Costantino took the photograph for the cover and prepared the report for publication, and Annette Kalicki produced the electronic versions for CBO's Web site ([www.cbo.gov](http://www.cbo.gov)).



Douglas Holtz-Eakin  
Director

September 2004

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## Summary

**T**he nation's fiscal situation has not changed much since the Congressional Budget Office (CBO) issued its previous baseline budget projections in March. Although the deficit for fiscal year 2004 is anticipated to be \$56 billion lower than CBO estimated then, the deficits projected for 2006 and beyond have grown.

In the absence of further legislation, the federal government will record a total budget deficit of \$422 billion in 2004. That deficit would represent a record level in dollar terms, but at 3.6 percent of the nation's gross domestic product (GDP), it would be smaller than the deficits of the mid-1980s and early 1990s relative to the size of the economy (during which time deficits frequently exceeded 4 percent of GDP).

Under the laws and policies currently in place, the deficit is projected to decline to \$348 billion, or 2.8 percent of GDP, in 2005, and outlays are estimated to continue to exceed revenues through 2014 (see Summary Table 1). Consequently, in CBO's projections, the cumulative deficit for 2005 through 2014 totals \$2.3 trillion, or 1.5 percent of total GDP. That outlook is substantially the same as it was in CBO's previous baseline projections, which cited a cumulative deficit of 1.3 percent of GDP.

By statute, CBO's baseline projections must estimate the future paths of federal revenues and spending under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to taxes and spending.

CBO expects solid growth in overall economic output during the next two years. Demand is now growing fast enough to spur producers to expand their capacity by investing in new capital (equipment and structures) and by hiring more workers. Led by large gains in business investment, GDP will expand by 4.5 percent in calendar year 2004, CBO forecasts, and by 4.1 percent in 2005;

from 2006 through 2014, annual growth of GDP will average 2.8 percent, according to CBO's projections. The average growth rate over the entire 2004-2014 period is 0.1 percentage point higher than in CBO's previous economic projections, published in January 2004.

Even if the economy grows more rapidly than projected, significant long-term strains on the budget will start to intensify within the next decade as the baby-boom generation begins to reach retirement age. By CBO's estimates, a growing elderly population and rapidly rising health care costs will cause total federal spending for Social Security, Medicare, and Medicaid to increase from more than 8 percent of GDP in 2004 to between 12 percent and 17 percent in 2030 and to between 13 percent and 28 percent in 2050 (depending on assumptions about federal spending and revenues in the future). Thus, over the long term, growing resource demands for those major entitlement programs will exert pressure on the budget that economic growth alone is unlikely to alleviate.

### The Budget Outlook

Assuming that current laws and policies remain unchanged, CBO projects that federal deficits will begin to decline after this year. In CBO's baseline, deficits drop as a percentage of GDP, from 3.6 percent in 2004 to 2.8 percent in 2005 and to 1.9 percent in 2010. After 2011—if the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expired as scheduled, discretionary spending continued to grow no faster than the rate of inflation, and other policies stayed the same—the budget would be relatively close to balance.

Total outlays are projected to remain steady at roughly 20 percent of GDP over the next 10 years. In CBO's baseline, mandatory spending grows approximately 1 percentage point faster than nominal GDP does, but discretionary spending is assumed to increase at the rate of inflation and thus at about half the growth rate of GDP.

**Summary Table 1.****CBO's Baseline Budget Outlook**

	Actual 2003													Total, 2005- 2009	Total, 2005- 2014
		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014			
<b>In Billions of Dollars</b>															
Total Revenues	1,782	1,871	2,094	2,279	2,406	2,531	2,673	2,821	3,077	3,308	3,471	3,648	11,983	28,308	
Total Outlays	2,158	2,293	2,442	2,577	2,714	2,849	2,985	3,119	3,276	3,378	3,547	3,713	13,568	30,601	
<b>Total Deficit</b>	<b>-375</b>	<b>-422</b>	<b>-348</b>	<b>-298</b>	<b>-308</b>	<b>-318</b>	<b>-312</b>	<b>-298</b>	<b>-200</b>	<b>-70</b>	<b>-75</b>	<b>-65</b>	<b>-1,584</b>	<b>-2,294</b>	
On-budget deficit	-536	-574	-521	-491	-519	-546	-554	-554	-468	-347	-359	-353	-2,631	-4,712	
Off-budget surplus <sup>a</sup>	161	153	173	193	211	228	242	256	268	277	283	288	1,047	2,418	
Debt Held by the Public at the End of the Year	3,914	4,334	4,694	5,009	5,329	5,660	5,984	6,295	6,506	6,588	6,675	6,753	n.a.	n.a.	
<b>As a Percentage of GDP</b>															
Total Revenues	16.4	16.2	17.0	17.7	17.8	17.9	18.0	18.2	19.0	19.5	19.6	19.8	17.7	18.6	
Total Outlays	19.9	19.8	19.8	20.0	20.1	20.1	20.1	20.1	20.2	20.0	20.1	20.1	20.0	20.1	
<b>Total Deficit</b>	<b>-3.5</b>	<b>-3.6</b>	<b>-2.8</b>	<b>-2.3</b>	<b>-2.3</b>	<b>-2.2</b>	<b>-2.1</b>	<b>-1.9</b>	<b>-1.2</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-2.3</b>	<b>-1.5</b>	
Debt Held by the Public at the End of the Year	36.1	37.5	38.2	38.8	39.4	39.9	40.3	40.5	40.1	38.9	37.8	36.6	n.a.	n.a.	

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

Net interest spending is projected to increase—because of continued deficits and rising interest rates—from 1.4 percent of GDP in 2004 to 2.1 percent in 2010. After that, as projected deficits shrink and debt held by the public declines as a share of the economy, net interest spending diminishes slightly as a percentage of GDP, reaching 1.9 percent by the end of the projection period.

The path of federal revenues over the next 10 years is shaped by the scheduled expiration of numerous tax provisions enacted between 2001 and 2003. Revenues are projected to rise sharply as a percentage of GDP over the next two years—from 16.2 percent this year to 17.0 percent in 2005 and 17.7 percent in 2006—largely because several major tax cuts will expire on December 31, 2004. Revenues are estimated to then increase gradually as a share of GDP, reaching 18.2 percent in 2010. If the remaining EGTRRA tax cuts expire in 2011, as scheduled, revenues will rise sharply again, reaching 19.8 percent of GDP in 2014, the highest level since 2001. The expiration of those tax cuts accounts for about 2.1 percentage

points of the projected increase of 3.6 percentage points in revenues as a share of GDP over the next decade.

In CBO's baseline, individual income taxes are responsible for almost all of the rise in revenues as a percentage of GDP over the next 10 years. Revenues from corporate income taxes increase relative to GDP in 2005 and 2006 but then fall back during the rest of the projection period. Other sources of revenues—the largest of which is social insurance taxes—remain relatively stable as a share of GDP.

In the six months since CBO's previous baseline was published, the outlook in terms of the deficits in 2004 and 2005 has improved, but the projection of the cumulative deficit over the 2005–2014 period has worsened. In March, CBO estimated that the deficit for 2004 would reach \$477 billion, the deficit for 2005 would decline to \$363 billion, and the cumulative 10-year deficit would be \$2.0 trillion. In its current baseline, CBO has lowered its estimate for this year's deficit by \$56 billion and for next year's deficit by \$15 billion. However, CBO has increased

**Summary Table 2.****Changes in CBO's Baseline Projections of the Deficit Since March 2004**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
Total Deficit as Projected in March 2004	-477	-363	-273	-274	-286	-281	-272	-176	-38	-34	-15	-1,477	-2,012
<b>Changes</b>													
Legislative													
Revenues	3	6	1	-1	-1	-2	-3	-2	-1	-1	-1	3	-5
Outlays <sup>a</sup>	1	29	38	42	45	48	51	54	58	62	66	201	492
Subtotal, legislative	3	-23	-37	-43	-46	-50	-54	-56	-59	-63	-67	-198	-497
Economic													
Revenues	14	29	31	33	35	41	43	44	40	35	30	169	361
Outlays <sup>a</sup>	*	5	15	18	18	18	19	21	22	24	27	74	188
Subtotal, economic	14	24	16	15	18	23	23	23	18	10	4	95	173
Technical													
Revenues	37	10	-9	-10	-8	-8	-4	*	-2	-2	-2	-25	-34
Outlays <sup>a</sup>	-2	-4	-4	-4	-4	-5	-8	-9	-11	-13	-15	-21	-77
Subtotal, technical	39	15	-5	-6	-4	-3	5	9	9	11	13	-4	43
<b>Total Effect on the Deficit<sup>b</sup></b>	<b>56</b>	<b>15</b>	<b>-26</b>	<b>-34</b>	<b>-32</b>	<b>-31</b>	<b>-26</b>	<b>-24</b>	<b>-33</b>	<b>-41</b>	<b>-50</b>	<b>-107</b>	<b>-281</b>
Total Deficit as Projected in September 2004	-422	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-1,584	-2,294

Source: Congressional Budget Office.

Note: \* = between -\$500 million and \$500 million.

a. Includes net interest payments.

b. Negative numbers represent an increase in the deficit.

its projection for the 10-year deficit by \$281 billion (see Summary Table 2).

Projected outlays have decreased slightly for 2004 but have grown by a total of \$603 billion (including debt-service costs) for the following 10 years. Most of that increase (\$492 billion) stems from newly enacted legislation—principally from extrapolating throughout the 10-year period the recent \$28 billion in supplemental appropriations for 2004 and the Department of Defense's appropriations for 2005. Changes in CBO's economic outlook have increased the estimate of 10-year outlays by another \$188 billion, primarily for spending sensitive to changes in inflation (such as discretionary spending and cost-of-living adjustments for Social Security). Technical estimating changes partially offset the legislative and eco-

nomic changes, lowering the spending estimate for the 10-year period by \$77 billion.

Projected revenues have increased by \$54 billion for 2004 and by \$322 billion for the 2005-2014 period. The economic revisions have boosted revenues in that period by a total of \$361 billion, whereas legislation enacted since March and technical changes together have decreased those revenues by \$39 billion.

## The Economic Outlook

In CBO's estimation, the economy has entered a phase of investment-led growth, in which the number of jobs is rising and real (inflation-adjusted) GDP is expanding faster than its trend rate. Indeed, CBO expects real GDP to grow strongly enough that the current excess capacity

in the economy will be eliminated by the end of calendar year 2005 (largely depending, however, on how lasting the recent surge in productivity turns out to be). The current assessment of the economy is similar to the one that CBO published in January—the only significant change to the two-year forecast being the likelihood of somewhat higher inflation.

CBO does not attempt to forecast business cycles more than two years into the future. Instead, its medium-term economic projections (through 2014) reflect a likely average for GDP over future cycles. As a result, CBO's projection of the growth of GDP keeps pace roughly with the agency's estimate of the trend growth of the economy—that is, potential GDP.<sup>1</sup> In CBO's estimates, real GDP growth averages 3.0 percent from 2006 to 2009 and 2.6 percent from 2010 to 2014 (see Summary Table 3). The slower growth projected for the latter half of the period stems primarily from a slowdown in the expansion of the labor force as the baby boomers begin to retire.

The rate of unemployment in CBO's two-year forecast and medium-term projections is related to the agency's estimate of the gap between GDP and potential GDP. As

that gap is eliminated over the next two years, CBO expects the unemployment rate to fall to 5.6 percent in 2004 and 5.2 percent in 2005 and then average 5.2 percent from 2006 through 2014.

According to CBO's forecast, inflation (as measured by the consumer price index) will be higher in 2004 (2.6 percent) than in 2003 (2.3 percent) as a result of more-rapid growth early this year in core prices, which exclude those for food and energy. Inflation will ease somewhat in 2005, declining to a rate of 2.0 percent. From 2006 through 2014, consumer prices will increase at an average annual rate of 2.2 percent, CBO projects. Altogether, price increases remain low by post-World War II standards.

Interest rates, especially short-term interest rates, are expected to rise as the economy continues to grow, but they too are likely to remain low by historical standards. The interest rate on three-month Treasury bills is forecast to increase from an average of just 1.0 percent in 2003 to 1.3 percent in 2004 and 2.6 percent in 2005; it is then expected to average 4.5 percent through 2014. Yields on 10-year Treasury notes are anticipated to rise by a smaller cumulative amount, from an average of 4.0 percent last year to 4.6 percent this year, 5.4 percent in 2005, and an average of 5.5 percent from 2006 through 2014.

---

1. Potential GDP is the level of real GDP that corresponds to a high level of use of resources (labor and capital).

**Summary Table 3.****CBO's Current and Previous Economic Projections for Calendar Years 2004 Through 2014**

	Actual 2003	Forecast		Projected Annual Average	
		2004	2005	2006-2009	2010-2014
<b>Nominal GDP (Billions of dollars)</b>					
September 2004	11,004	11,753	12,464	15,016 <sup>a</sup>	18,628 <sup>b</sup>
January 2004	10,980	11,629	12,243	14,686 <sup>a</sup>	18,266 <sup>b</sup>
<b>Nominal GDP (Percentage change)</b>					
September 2004	4.9	6.8	6.1	4.8	4.4
January 2004	4.8	5.9	5.3	4.7	4.5
<b>Real GDP (Percentage change)</b>					
September 2004	3.0	4.5	4.1	3.0	2.6
January 2004	3.2	4.8	4.2	2.8	2.5
<b>GDP Price Index (Percentage change)</b>					
September 2004	1.8	2.2	1.8	1.7	1.8
January 2004	1.6	1.1	1.1	1.8	1.9
<b>Consumer Price Index<sup>c</sup> (Percentage change)</b>					
September 2004	2.3	2.6	2.0	2.2	2.2
January 2004	2.3	1.6	1.7	2.2	2.2
<b>Unemployment Rate (Percent)</b>					
September 2004	6.0	5.6	5.2	5.2	5.2
January 2004	6.0	5.8	5.3	5.1	5.2
<b>Three-Month Treasury Bill Rate (Percent)</b>					
September 2004	1.0	1.3	2.6	4.5	4.6
January 2004	1.0	1.3	3.0	4.5	4.6
<b>Ten-Year Treasury Note Rate (Percent)</b>					
September 2004	4.0	4.6	5.4	5.5	5.5
January 2004	4.0	4.6	5.4	5.5	5.5

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. Level in 2009.

b. Level in 2014.

c. The consumer price index for all urban consumers.

## 1

## The Budget Outlook

**T**he nation's fiscal outlook has not changed substantially since March, when the Congressional Budget Office (CBO) issued its previous baseline budget projections.<sup>1</sup> The deficits estimated for fiscal years 2004 and 2005 have shrunk somewhat, but the deficits projected for later years have grown.

In the absence of further legislation, the federal government will record a total budget deficit of \$422 billion in 2004, CBO anticipates—about \$56 billion less than it estimated six months ago. That deficit would represent a record level in dollar terms, but at 3.6 percent of the nation's gross domestic product (GDP), it would be smaller than the deficits of the mid-1980s and early 1990s relative to the size of the economy (see Figure 1-1). Thereafter, if current laws and policies do not change, annual deficits will decline to 2.8 percent of GDP (\$348 billion) in 2005 and to 0.4 percent of GDP (\$65 billion) by 2014, for a cumulative 10-year deficit of \$2.3 trillion, CBO projects (see Table 1-1). That cumulative deficit equals 1.5 percent of projected GDP over the 10-year period—up slightly from the 1.3 percent figure in CBO's March baseline.

Federal debt held by the public will equal 37.5 percent of GDP at the end of this fiscal year, CBO estimates. In its baseline, such debt increases slowly in relation to the size of the economy, peaking at more than 40 percent of GDP in 2010. After that year—when recent tax cuts are scheduled to expire—lower projected deficits slow the growth in the government's need to borrow, and debt held by the public shrinks as a share of GDP.

CBO's baseline projections are constructed according to rules set forth in law (mainly in the Balanced Budget and

Emergency Deficit Control Act of 1985 and the Congressional Budget and Impoundment Control Act of 1974). Because they assume that current laws and policies do not change, they are not intended to be a prediction of future budgetary outcomes; instead, CBO's baseline is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to taxes and spending. Actual budget totals will almost certainly differ from the baseline projections.

For revenues and mandatory spending, the assumption that present laws continue without change means that CBO's baseline assumes that the tax cuts enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) will expire as scheduled.

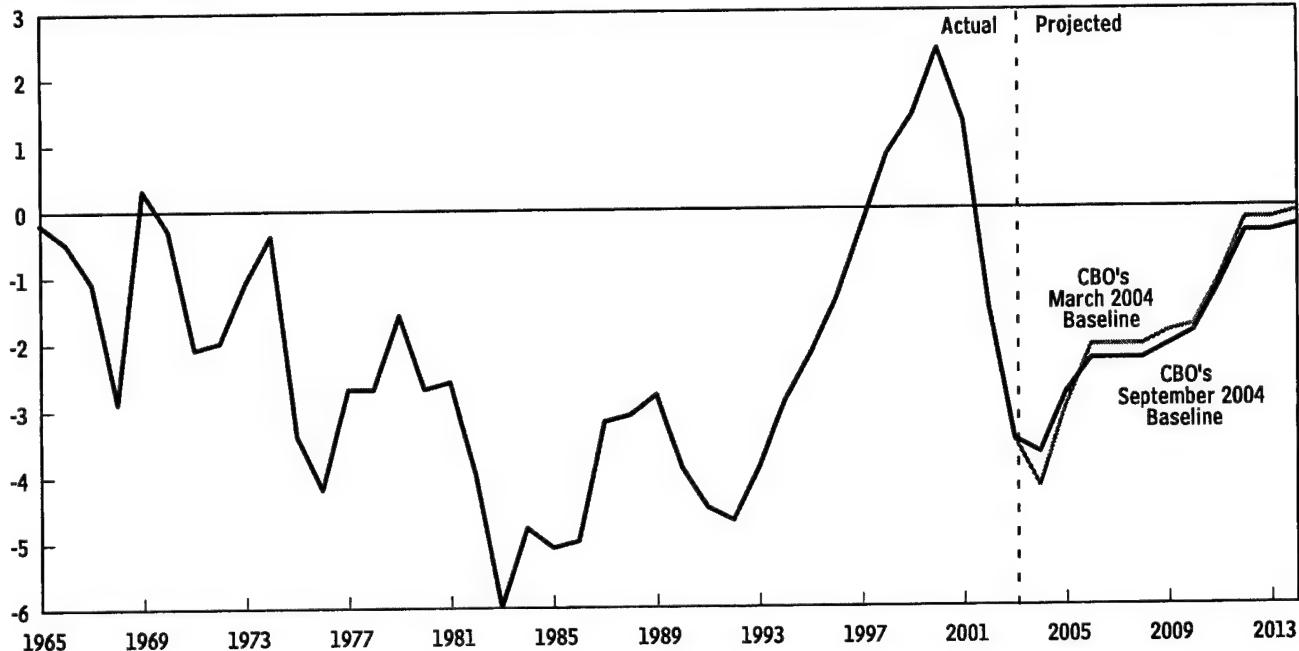
For discretionary spending, which is governed by annual appropriation acts, the Deficit Control Act specifies that if appropriations for the coming budget year have not yet been enacted, discretionary spending should be projected by adjusting the current year's budget authority to reflect inflation and other factors. Normally, appropriations for the budget year have not been enacted when CBO prepares its summer baseline, so projections for discretionary programs are based on current-year appropriations. In this case, however, the Department of Defense Appropriations Act, 2005 was enacted on August 5. Consequently, the levels of budget authority for 2005 included in that law have been incorporated into CBO's current baseline and projected through 2014.

The newly enacted defense appropriations do not include any budget authority specifically for 2005 for military and reconstruction activities in Iraq and Afghanistan. Funding for such activities in 2004 was provided through supplemental appropriations, which totaled \$115 bil-

1. Those projections were published in Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2005* (March 2004).

**Figure 1-1.****Total Deficits and Surpluses as a Share of GDP, 1965 to 2014**

(Percentage of GDP)



Source: Congressional Budget Office.

lion.<sup>2</sup> The baseline reflects that funding for the current year and extrapolates it through the projection period.

Although CBO's baseline projections cannot incorporate possible policy changes, this report shows the budgetary implications over the next 10 years of some alternative policy assumptions. For example, the assumption that current funding for activities in Iraq and Afghanistan does not continue after 2004 shrinks the projected 10-year deficit from \$2.3 trillion to \$0.9 trillion. Debt held by the public at the end of 2014 drops from 36.6 percent of GDP to 28.9 percent.

Similarly, as noted above, the baseline must follow the assumption that all of the tax provisions set to expire over the next 10 years actually do so. However, if all of those provisions (except the higher personal exemptions for the

alternative minimum tax) were extended, the projected deficit for 2014 would grow from 0.4 percent of GDP to 2.9 percent of GDP. The 10-year deficit would total 3.0 percent of GDP (\$4.5 trillion) instead of 1.5 percent (\$2.3 trillion), and debt held by the public at the end of 2014 would climb to 48.8 percent of GDP from 36.6 percent.<sup>3</sup>

Since March, revisions to CBO's baseline have reduced the deficit projected for this year by \$56 billion. Virtually all of that improvement is attributable to higher-than-expected revenues collected so far this year. In contrast, for the 2005-2014 period, revisions to the baseline have added \$281 billion to the cumulative deficit. Legislation enacted since March (primarily the 2005 defense appropriation act, which included additional supplemental funding for 2004) accounts for the biggest change to the 10-year deficit, increasing it by \$497 billion. Revisions stemming from changes in CBO's economic forecast par-

2. That \$115 billion, which includes a small amount of funding unrelated to activities in Iraq and Afghanistan, comprises funding in two acts that provided supplemental appropriations for 2004. The first, enacted in November 2003, provided \$87 billion. The second, the Department of Defense Appropriations Act, 2005, provided another \$28 billion for 2004 (including \$1.8 billion from reversing a rescission that had previously been enacted but not yet applied).

3. CBO's baseline incorporates the effects that the expiration of tax cuts have on the economy. By contrast, CBO's estimate of the budgetary effects of permanently extending those tax cuts does not include any macroeconomic effects (which are likely to be small relative to the overall economy).

**Table 1-1.****Projected Deficits and Surpluses in CBO's Baseline**

(Billions of dollars)

	Actual													Total, 2005-2009	Total, 2005-2014
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2009	2014	
On-Budget Deficit	-536	-574	-521	-491	-519	-546	-554	-554	-468	-347	-359	-353	-2,631	-4,712	
Off-Budget Surplus <sup>a</sup>	161	153	173	193	211	228	242	256	268	277	283	288	1,047	2,418	
<b>Total Deficit</b>	<b>-375</b>	<b>-422</b>	<b>-348</b>	<b>-298</b>	<b>-308</b>	<b>-318</b>	<b>-312</b>	<b>-298</b>	<b>-200</b>	<b>-70</b>	<b>-75</b>	<b>-65</b>	<b>-1,584</b>	<b>-2,294</b>	
<b>Memorandum:</b>															
Social Security Surplus	156	149	171	190	208	225	239	252	264	272	278	282	1,033	2,381	
Postal Service Outlays	-5	-3	-2	-3	-3	-3	-4	-4	-4	-5	-5	-5	-15	-38	
Total Deficit as a Percentage of GDP	-3.5	-3.6	-2.8	-2.3	-2.3	-2.2	-2.1	-1.9	-1.2	-0.4	-0.4	-0.4	-2.3	-1.5	
Debt Held by the Public as a Percentage of GDP	36.1	37.5	38.2	38.8	39.4	39.9	40.3	40.5	40.1	38.9	37.8	36.6	n.a.	n.a.	

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

tially offset that increase. CBO has raised its forecast for real (inflation-adjusted) economic growth slightly; the effect of that change on projected revenues, coupled with the impact of other economic revisions, reduces the projected 10-year deficit by \$173 billion. Finally, technical revisions to the baseline shrink that deficit by another \$43 billion.

Over the longer term, the federal budget will face significant strains, which will begin during the current 10-year projection period and intensify as more of the baby-boom generation reaches retirement age. In the next 30 years, the number of people age 65 or older will double, while the number of adults under age 65 will rise by less than 15 percent. In addition to those demographic changes, costs per enrollee in federal health care programs are likely to continue growing faster than inflation.

CBO projects that those pressures will cause federal spending for Social Security, Medicare, and Medicaid combined to increase from more than 8 percent of GDP this year to between 12 percent and 17 percent in 2030 and between 13 percent and 28 percent in 2050 (depending on assumptions about federal spending and revenues in the future). Over the long term, growing resource de-

mands for those major entitlement programs will exert pressure on the budget that economic growth alone is unlikely to alleviate; left unchecked, such demands could pose an obstacle to higher standards of living.

## A Look at 2004

The total federal budget deficit will grow from \$375 billion (3.5 percent of GDP) in 2003 to \$422 billion (3.6 percent of GDP) in 2004, CBO anticipates (see Table 1-2). Although revenues are projected to rise by 5.0 percent this year, spending is expected to grow faster, by 6.3 percent.

### Outlays

CBO expects total outlays to increase by \$136 billion in 2004, with that growth divided almost evenly between discretionary and mandatory programs. Outlays for discretionary programs (the part of the budget whose spending levels are set anew each year in appropriation acts) are projected to rise by \$63 billion, or 7.6 percent. Outlays for entitlements and other mandatory programs (whose spending is usually governed by eligibility rules and benefit levels set forth in existing laws) are projected to increase by \$67 billion, or 5.7 percent. Net interest (the

**Table 1-2.****CBO's Baseline Budget Projections**

	Actual												Total, 2005-	Total, 2005-
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2009	2014
<b>In Billions of Dollars</b>														
<b>Revenues</b>														
Individual income taxes	794	811	923	1,031	1,110	1,183	1,273	1,376	1,576	1,732	1,834	1,945	5,519	13,982
Corporate income taxes	132	182	227	249	251	255	258	261	265	270	275	281	1,240	2,591
Social insurance taxes	713	732	792	836	877	916	958	1,001	1,045	1,091	1,138	1,186	4,379	9,838
Other	144	147	152	163	169	178	184	184	191	215	225	236	846	1,896
<b>Total</b>	<b>1,782</b>	<b>1,871</b>	<b>2,094</b>	<b>2,279</b>	<b>2,406</b>	<b>2,531</b>	<b>2,673</b>	<b>2,821</b>	<b>3,077</b>	<b>3,308</b>	<b>3,471</b>	<b>3,648</b>	<b>11,983</b>	<b>28,308</b>
On-budget	1,259	1,338	1,519	1,672	1,769	1,863	1,973	2,089	2,312	2,510	2,639	2,779	8,796	21,125
Off-budget	524	534	575	606	637	668	700	732	764	798	833	868	3,187	7,183
<b>Outlays</b>														
Discretionary spending	825	888	965	1,000	1,020	1,046	1,069	1,093	1,123	1,140	1,172	1,199	5,100	10,827
Mandatory spending	1,179	1,247	1,299	1,360	1,439	1,522	1,614	1,707	1,822	1,898	2,032	2,165	7,233	16,857
Net interest	153	159	178	217	255	281	302	319	332	340	343	348	1,234	2,917
<b>Total</b>	<b>2,158</b>	<b>2,293</b>	<b>2,442</b>	<b>2,577</b>	<b>2,714</b>	<b>2,849</b>	<b>2,985</b>	<b>3,119</b>	<b>3,276</b>	<b>3,378</b>	<b>3,547</b>	<b>3,713</b>	<b>13,568</b>	<b>30,601</b>
On-budget	1,795	1,912	2,039	2,164	2,288	2,409	2,527	2,643	2,780	2,857	2,997	3,132	11,427	25,837
Off-budget	363	381	403	413	426	441	458	477	496	521	549	580	2,140	4,765
<b>Deficit (-) or Surplus</b>	<b>-375</b>	<b>-422</b>	<b>-348</b>	<b>-298</b>	<b>-308</b>	<b>-318</b>	<b>-312</b>	<b>-298</b>	<b>-200</b>	<b>-70</b>	<b>-75</b>	<b>-65</b>	<b>-1,584</b>	<b>-2,294</b>
On-budget	-536	-574	-521	-491	-519	-546	-554	-554	-468	-347	-359	-353	-2,631	-4,712
Off-budget	161	153	173	193	211	228	242	256	268	277	283	288	1,047	2,418
Debt Held by the Public	3,914	4,334	4,694	5,009	5,329	5,660	5,984	6,295	6,506	6,588	6,675	6,753	n.a.	n.a.
<b>Memorandum:</b>														
Gross Domestic Product	10,841	11,559	12,304	12,909	13,522	14,173	14,846	15,526	16,220	16,931	17,667	18,433	67,755	152,530
<b>As a Percentage of GDP</b>														
<b>Revenues</b>														
Individual income taxes	7.3	7.0	7.5	8.0	8.2	8.3	8.6	8.9	9.7	10.2	10.4	10.6	8.1	9.2
Corporate income taxes	1.2	1.6	1.8	1.9	1.9	1.8	1.7	1.7	1.6	1.6	1.6	1.5	1.8	1.7
Social insurance taxes	6.6	6.3	6.4	6.5	6.5	6.5	6.5	6.4	6.4	6.4	6.4	6.4	6.5	6.5
Other	1.3	1.3	1.2	1.3	1.2	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.2	1.2
<b>Total</b>	<b>16.4</b>	<b>16.2</b>	<b>17.0</b>	<b>17.7</b>	<b>17.8</b>	<b>17.9</b>	<b>18.0</b>	<b>18.2</b>	<b>19.0</b>	<b>19.5</b>	<b>19.6</b>	<b>19.8</b>	<b>17.7</b>	<b>18.6</b>
On-budget	11.6	11.6	12.3	13.0	13.1	13.1	13.3	13.5	14.3	14.8	14.9	15.1	13.0	13.8
Off-budget	4.8	4.6	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7	4.7
<b>Outlays</b>														
Discretionary spending	7.6	7.7	7.8	7.7	7.5	7.4	7.2	7.0	6.9	6.7	6.6	6.5	7.5	7.1
Mandatory spending	10.9	10.8	10.6	10.5	10.6	10.7	10.9	11.0	11.2	11.2	11.5	11.7	10.7	11.1
Net interest	1.4	1.4	1.4	1.7	1.9	2.0	2.0	2.1	2.0	2.0	1.9	1.9	1.8	1.9
<b>Total</b>	<b>19.9</b>	<b>19.8</b>	<b>19.8</b>	<b>20.0</b>	<b>20.1</b>	<b>20.1</b>	<b>20.1</b>	<b>20.1</b>	<b>20.2</b>	<b>20.0</b>	<b>20.1</b>	<b>20.1</b>	<b>20.0</b>	<b>20.1</b>
On-budget	16.6	16.5	16.6	16.8	16.9	17.0	17.0	17.0	17.1	16.9	17.0	17.0	16.9	16.9
Off-budget	3.3	3.3	3.3	3.2	3.2	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.2	3.1
<b>Deficit (-) or Surplus</b>	<b>-3.5</b>	<b>-3.6</b>	<b>-2.8</b>	<b>-2.3</b>	<b>-2.3</b>	<b>-2.2</b>	<b>-2.1</b>	<b>-1.9</b>	<b>-1.2</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-2.3</b>	<b>-1.5</b>
On-budget	-4.9	-5.0	-4.2	-3.8	-3.8	-3.9	-3.7	-3.6	-2.9	-2.0	-2.0	-1.9	-3.9	-3.1
Off-budget	1.5	1.3	1.4	1.5	1.6	1.6	1.6	1.6	1.7	1.6	1.6	1.6	1.5	1.6
Debt Held by the Public	36.1	37.5	38.2	38.8	39.4	39.9	40.3	40.5	40.1	38.9	37.8	36.6	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

government's interest payments on debt held by the public, offset by interest income and earnings that it receives) is expected to rise by \$5 billion, or 3.6 percent, this year.

**Discretionary Spending.** Defense programs remain the fastest growing component of discretionary spending. Their overall budget authority increased by 7 percent (\$31 billion) in 2004, after rising by 26 percent (\$94 billion) last year and 9 percent (\$29 billion) in 2002. Some of those increases stem from supplemental appropriations for defense—mainly to fund operations in Iraq and Afghanistan—which grew from \$62 billion in 2003 to a total of \$92 billion in 2004. Budget authority for defense activities not directly associated with Iraq and Afghanistan has also grown. In 2001, defense appropriations totaled \$318 billion excluding funds made available in response to the September 11 terrorist attacks; by 2004, defense funding totaled \$394 billion excluding supplemental appropriations. As a result of the recent increases in budget authority, outlays for national defense will total \$452 billion in 2004, CBO estimates, almost 12 percent more than last year. (The most recently enacted supplemental appropriations, which contain \$27 billion in budget authority for defense, are not expected to have a significant impact on outlays in 2004.)

Although most major components of defense spending continue to increase at double-digit rates, an exception is spending for military personnel. CBO expects that such spending will grow by 6.1 percent this year, far smaller than the adjusted growth rate of 13.6 percent seen last year with the onset of the war in Iraq.<sup>4</sup> With spending on pay and benefits for military personnel excluded, defense outlays would rise by about 14 percent (rather than 12 percent) this year, CBO estimates—roughly the same rate as in 2002 and 2003.

Funding provided for nondefense discretionary programs—which includes budget authority for discretionary activities other than defense as well as obligation limitations for certain transportation programs—rose by 6 percent in 2004, up from a growth rate of 4.9 percent the

4. In 2003, the Department of Defense (DoD) implemented an accrual accounting system to record the costs of health benefits provided to certain military retirees. That new system affects outlays in a number of DoD accounts, including accounts that fund pay and benefits for military personnel. Some of those outlays, however, represent new intragovernmental payments that do not affect net spending. The 13.6 percent growth rate for 2003 is adjusted to exclude the effects of those payments.

previous year. However, both of those rates are significantly lower than the double-digit growth rates experienced in 2001 and 2002.

Outlays for nondefense discretionary programs will increase by 3.6 percent (\$15 billion) in 2004—far slower than the 9.3 percent growth rate in 2003—and will total \$436 billion, CBO estimates. That projected slowdown in growth is attributable to several factors. In general, it reflects the diminishing effect of the large funding increases that occurred in 2001 and 2002. In addition, outlays for border and transportation security activities of the Department of Homeland Security are likely to be about \$5 billion lower in 2004 than they were last year, when they included one-time payments for security-screening equipment at airports and \$2.3 billion for assistance to airlines. Outlays for disaster relief—which were much higher than usual in the aftermath of the attacks of September 11, 2001—are expected to drop by about \$2 billion from last year's level.<sup>5</sup> Moreover, outlays for education are expected to grow by about 8 percent this year, compared with 18 percent in 2003, because appropriations in the past two years have not increased as rapidly as in previous years. (Budget authority for discretionary education programs rose at an average rate of nearly 20 percent a year during the 1999–2002 period; in 2003 and 2004, it grew by about 7 percent and 5 percent, respectively.)

Outlays for reconstruction activities in Iraq are expected to total \$2.7 billion in 2004. Although that amount is a significant increase from last year's level, it represents less than 15 percent of the funding made available in 2004 for that purpose. Continuing security challenges in Iraq have impeded the obligation and expenditure of money on reconstruction projects.

**Mandatory Spending.** Mandatory outlays (net of offsetting receipts) are projected to rise by 5.7 percent this year, less than the 6.6 percent growth recorded in 2003. However, the three largest mandatory programs will grow faster in 2004 than they did last year, CBO estimates—Social Security by 4.5 percent (versus 4.1 percent in 2003), Medicare by 8.1 percent (compared with 7.9 percent in 2003), and Medicaid by 9.4 percent (versus 8.9 percent last year). In the case of Medicaid, that rise stems from a temporary increase in the federal government's

5. That projection does not include funding in response to Hurricane Charley, which is not expected to affect 2004 outlays.

share of the program's costs. The higher share ended on June 30.

Among other mandatory programs, spending for the September 11th Victim Compensation Fund is expected to rise from less than \$1 billion in 2003 to more than \$6 billion in 2004. In addition, in 2004 the Federal Housing Administration's Mutual Mortgage Insurance program recorded a large reestimate of the costs of its mortgage guarantees made in previous years, which raised its outlays from \$1.5 billion in 2003 to \$7 billion this year.

Despite those increases, total mandatory spending is expected to grow more slowly in 2004 than in 2003 mainly because of a significant decrease in spending related to unemployment insurance. Last year, a temporary emergency unemployment compensation program gave long-term unemployed people 13 additional weeks of benefits. Those extended benefits were phased out at the beginning of 2004, which, combined with a decline in the unemployment rate, has decreased projected outlays for unemployment compensation this year by \$11.5 billion, or 21 percent. In addition, spending for farm price- and income-support programs will drop by 38 percent (to \$9.5 billion) in 2004, CBO estimates, because higher prices for agricultural commodities have lessened the need for government assistance.

**Net Interest.** CBO expects net interest costs to rise by about \$5 billion this year. That growth reflects an increase in the outstanding amount of federal debt held by the public, higher compensation for inflation on Treasury inflation-protected securities (TIPS), and other factors.

### Revenues

After three years of decline, revenues are projected to increase by \$89 billion, or about 5 percent, in 2004. However, because that increase is slower than the growth of nominal GDP, revenues will continue to fall as a share of GDP: from 16.4 percent in 2003 to 16.2 percent this year.

Revenues from individual income taxes and social insurance (or payroll) taxes, which are tied to personal income, are expected to rise much more slowly this year than revenues from corporate income taxes, which depend on corporate profitability. CBO's projected growth rates are 2.2 percent (\$17 billion) for individual income tax receipts and 2.7 percent (\$19 billion) for social insurance receipts, compared with 38 percent (\$50 billion) for corporate in-

come tax receipts. Other tax sources, which account for less than 10 percent of revenues, are projected to increase by 2 percent (\$3 billion).

**Individual Income and Social Insurance Tax Receipts.** A large share of this year's growth in individual income and payroll taxes has occurred in withholding from employees' paychecks. CBO expects combined withholding for those taxes to rise by 2.3 percent (about \$32 billion) in 2004.<sup>6</sup> Withholding typically follows the same pattern as total wage and salary income in the economy, which CBO projects will rise by 4.8 percent this year. However, receipts from withholding are growing more slowly than wage and salary income because of the cuts in individual income taxes enacted in EGTRRA and accelerated by JGTRRA. Those cuts included reductions in tax rates and the expansion of certain tax brackets. If the effects of those tax cuts were excluded, withholding would increase more than twice as fast this year—by about 5 percent—CBO estimates.

In addition to withholding, unemployment insurance receipts (a component of social insurance tax receipts) are projected to grow by just over 20 percent, or about \$7 billion, in 2004. States have raised their unemployment insurance taxes to replenish the trust funds they use to pay unemployment insurance benefits, which were depleted during the most recent recession. (State employment taxes are remitted to the federal government and recorded as receipts in the federal budget.)

Nonwithheld payments of individual income and social insurance taxes (net of refunds) have been relatively stable in 2004, and CBO expects them to decline by only about \$2 billion. Gross payments of income and payroll taxes—consisting both of quarterly estimated payments for taxes in the current year and final payments for the prior year's taxes (usually made in April)—are projected to fall by \$6 billion, or about 2 percent. Refunds of individual income taxes are expected to decline by about \$4 billion, also about 2 percent. (The change in refunds this year would

6. Employers withhold both income and payroll taxes from paychecks and remit the combined amount to the Internal Revenue Service without being required to identify the separate components. The Treasury Department estimates that allocation when it receives the withheld amount and later corrects its estimates as more data become available. Consequently, when CBO analyzes recent data on collections of withheld taxes, it considers income and payroll taxes together to avoid measurement errors associated with the components.

have been an increase of about \$10 billion, or 5 percent, had refunds in 2003 not been expanded by payments of legislated advance rebates last summer.)

CBO and other analysts had expected individual income tax refunds to grow sharply this year because of the tax provisions enacted in JGTRRA. They anticipated that taxpayers filing returns for 2003 would receive large one-time refunds because that law's cuts in tax rates and other changes were made effective on January 1, 2003, whereas the changes in withholding rates did not take effect until after late May (when the law was enacted). CBO still estimates that JGTRRA's tax changes substantially increased refunds in 2004, but it appears that other factors—which will remain unclear until individual income tax returns for 2003 are fully processed next year—held down refunds.

**Corporate Income Tax Receipts.** Corporations' before-tax profits—so-called book profits—are expected to increase by about 20 percent this year, exceeding last year's strong growth rate of 17 percent. The rise in the growth of profits has boosted corporate tax receipts in 2004. Another contributor to this year's increase in net corporate tax receipts is reduced refunds of corporate taxes paid in previous years. Companies can obtain such "carryback refunds" if they incur a loss in the current year and paid taxes in either of the two prior years. Many firms that were unprofitable last year and received refunds may now be profitable and paying taxes.

## Baseline Budget Projections for 2005 Through 2014

CBO projects that if current laws and policies remain the same, the annual budget deficit will drop to 2.8 percent of GDP in 2005 and gradually decrease thereafter, reaching 1.9 percent in 2010 (see Table 1-2). After that, primarily because of increased revenues from the scheduled expiration of the tax cuts enacted in EGTRRA, the baseline deficit drops considerably, reaching a low of 0.4 percent of GDP in 2012 and continuing at that level through 2014.

### Outlays

Under current laws and policies, total outlays are projected to remain steady at roughly 20 percent of GDP over the next 10 years. In CBO's baseline, mandatory spending grows approximately 1 percentage point faster than nominal GDP does, but discretionary spending is

assumed to increase at the rate of inflation and thus at about half the growth rate of GDP. Net interest spending is projected to increase, because of continued deficits and rising interest rates, from 1.4 percent of GDP in 2004 to 2.1 percent in 2010. After that, as projected deficits shrink and debt held by the public declines as a share of the economy, net interest spending diminishes slightly as a percentage of GDP, reaching 1.9 percent by the end of the projection period.

**Discretionary Spending.** According to the Deficit Control Act, CBO's baseline must assume that discretionary spending will continue at the level of the most recent appropriations, with annual increases based on two projected rates of inflation: the GDP deflator and the employment cost index for wages and salaries. For most discretionary accounts, the most recent appropriations were made for 2004. However, appropriations for Department of Defense activities and for certain programs funded in the defense appropriation act have already been enacted for 2005; CBO has incorporated those appropriations in this baseline.

Besides the 13 regular appropriation acts that provide funding, two appropriation acts contained supplemental budget authority for 2004, primarily for operations in Iraq and other activities associated with the global war on terrorism. Both the \$87 billion in budget authority provided in November 2003 and the \$28 billion provided in August 2004 have been included in the total for 2004 that is extrapolated through 2014, in accordance with baseline rules.

With all of those components of current discretionary appropriations taken into account, outlays are projected to increase from \$888 billion this year to nearly \$1.2 trillion in 2014 (see Table 1-3). Over the 2005-2014 period, discretionary outlays grow at an average annual rate of 3.1 percent in CBO's baseline. (The budgetary effects of alternative assumptions about the growth of discretionary spending are discussed in the section that begins on page 14.)

Because of the nation's continuing concern about homeland security, the Administration has identified the spending that it considers related to such activities, and CBO follows the Administration's classification. Net discretionary budget authority for homeland security is estimated to total about \$36 billion this year—\$9 billion for defense and \$27 billion for nondefense programs. The

**Table 1-3.****CBO's Baseline Projections of Discretionary Spending and Homeland Security Spending**

(Billions of dollars)

	Total, 2005-2014													
	Actual 2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2009	2014
<b>Total Discretionary Spending in CBO's Baseline<sup>a</sup></b>														
<b>Budget Authority</b>														
Defense	455	486	511	522	534	546	559	573	586	601	616	631	2,672	5,679
Nondefense	394	418	437	443	453	464	477	486	498	510	522	534	2,274	4,824
<b>Total</b>	<b>849</b>	<b>904</b>	<b>948</b>	<b>965</b>	<b>987</b>	<b>1,010</b>	<b>1,036</b>	<b>1,059</b>	<b>1,084</b>	<b>1,111</b>	<b>1,137</b>	<b>1,165</b>	<b>4,947</b>	<b>10,503</b>
<b>Outlays</b>														
Defense	405	452	497	514	523	539	551	565	583	588	607	622	2,623	5,588
Nondefense	420	436	468	487	497	507	518	528	540	552	565	577	2,477	5,239
<b>Total</b>	<b>825</b>	<b>888</b>	<b>965</b>	<b>1,000</b>	<b>1,020</b>	<b>1,046</b>	<b>1,069</b>	<b>1,093</b>	<b>1,123</b>	<b>1,140</b>	<b>1,172</b>	<b>1,199</b>	<b>5,100</b>	<b>10,827</b>
<b>Discretionary Spending Classified as Homeland Security Spending<sup>b</sup></b>														
<b>Budget Authority</b>														
Defense	10	9	10	10	11	11	11	12	12	12	13	13	53	114
Nondefense <sup>c</sup>	28	27	30	28	28	29	32	31	31	32	33	34	146	308
<b>Total</b>	<b>38</b>	<b>36</b>	<b>40</b>	<b>38</b>	<b>39</b>	<b>40</b>	<b>43</b>	<b>42</b>	<b>43</b>	<b>44</b>	<b>46</b>	<b>47</b>	<b>200</b>	<b>422</b>
<b>Outlays</b>														
Defense	8	9	10	10	11	11	11	11	12	12	12	13	52	113
Nondefense	23	22	26	28	30	30	30	31	32	32	33	34	144	305
<b>Total</b>	<b>31</b>	<b>31</b>	<b>36</b>	<b>38</b>	<b>40</b>	<b>41</b>	<b>41</b>	<b>42</b>	<b>43</b>	<b>44</b>	<b>45</b>	<b>46</b>	<b>196</b>	<b>418</b>

Source: Congressional Budget Office.

Note: Discretionary outlays are usually higher than budget authority because of spending from the Highway Trust Fund and the Airport and Airway Trust Fund, which is subject to obligation limitations set in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary.

- a. Inflation in CBO's baseline is projected using the inflators specified in the Balanced Budget and Emergency Deficit Control Act of 1985: the GDP deflator and the employment cost index for wages and salaries.
- b. The amounts shown here reflect net spending for homeland security activities (about \$3 billion to \$4 billion a year in spending is offset by fees and other receipts). CBO's classification of homeland security funding is based on designations established by the Administration. Those designations are not limited to the activities of the Department of Homeland Security. In fact, some activities of the department (such as disaster relief) are not included in the definition, whereas nondepartmental activities (such as some defense-related programs and some funding for the National Institutes of Health) fall within the Administration's definition of homeland security. About half of all spending considered to be for homeland security is for activities outside the Department of Homeland Security.
- c. Project BioShield, an initiative to expand the government's arsenal of counter-bioterrorism agents, has appropriations for 2004, 2005, and 2009 in CBO's baseline. Budget authority for all other years is zero.

discretionary outlays resulting from that budget authority will total \$31 billion this year, CBO estimates. (In addition, roughly \$1 billion a year in net outlays for homeland security are classified as mandatory spending.) Over the next 10 years, discretionary outlays for homeland security will average slightly less than 0.3 percent of GDP, under CBO's baseline assumptions. Those outlays reflect \$5.6 billion in appropriations already provided for Project BioShield, an initiative to develop drugs and vaccines to counter attacks by biological and chemical weapons—\$885 million for 2004, \$2.5 billion for 2005, and \$2.2 billion for 2009.

**Mandatory Spending.** Outlays for mandatory programs are generally determined by eligibility rules and benefit levels set in law rather than through the annual appropriation process. CBO estimates that under current law, those outlays (excluding offsetting receipts) will grow at an average rate of 5.8 percent a year through 2014. That growth is fueled by spending for Social Security, Medicare, and Medicaid, which together account for more than three-quarters of mandatory outlays (see Table 1-4).

Ten-year averages, however, do not fully reveal the long-term trends propelling the growth of outlays for those programs. As baby boomers begin to qualify for Social Security and Medicare in the second half of this decade, the underlying growth of spending for those programs will accelerate. For example, outlays for Social Security are projected to increase by about 4.2 percent in 2006; however, by 2014, that growth rate will rise to 6.4 percent. In the case of Medicare, the introduction of a prescription drug benefit in 2006 is projected to help boost that program's federal outlays by a total of 30.6 percent between 2005 and 2007.<sup>7</sup> Over the following seven years, the growth of Medicare spending will continue at a robust rate of 7.6 percent a year, CBO projects, driven by increases in participation and in utilization of medical services.

7. CBO projects that the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, which established the prescription drug benefit and made other changes to the Medicare program, will add a total of \$395 billion to federal outlays from 2004 through 2013. That amount comprises \$770 billion in additional Medicare outlays, partially offset by \$375 billion in savings to Medicaid and other programs, transfer payments from states, and beneficiaries' premium payments. Those estimates have not changed since CBO issued its previous baseline budget projections.

The annual growth rate of Medicaid spending, which was roughly 9 percent in 2003 and 2004, is projected to dip to just under 4 percent in 2005 and 2006 because of recent legislation. In 2006, Medicaid will begin to realize substantial savings as Medicare assumes the cost of prescription drugs for people who are eligible for both programs. However, Medicaid's growth rate is projected to head back up toward the previous level beginning in 2007 and to average 8.8 percent annually during the last seven years of the projection period.

Overall, CBO projects that under current law, mandatory spending (excluding offsetting receipts) will equal 11.5 percent of GDP in 2005 and increase thereafter, reaching 13.0 percent in 2014. Spending for Social Security, Medicare, and Medicaid combined is projected to grow from 8.3 percent of GDP in 2005 to 10.3 percent in 2014, at which point those three programs would account for more than half of all federal spending (under current law). Other mandatory programs are projected to decline as a share of GDP.

**Net Interest.** Interest costs—mainly on accumulated federal debt—will account for almost 10 percent of total outlays over the 2005-2014 period, CBO estimates. Those costs reached a nadir in 2003, but they are projected to grow steadily during the projection period: from \$178 billion in 2005 to \$348 billion in 2014 (see Table 1-5). That rise reflects projected increases both in interest rates and in federal borrowing. Under CBO's baseline assumptions, net interest will peak relative to GDP at 2.1 percent in 2010 and then decline through 2014. (The baseline assumes that the statutory limit on federal borrowing is raised as necessary to cover projected deficits. For more information about that limit, see Box 1-1 on page 12.)

## Revenues

Under current law, the path of federal revenues over the next 10 years is shaped by the scheduled expiration of numerous tax provisions. Revenues are projected to rise sharply as a percentage of GDP over the next two years—from 16.2 percent this year to 17.0 percent in 2005 and 17.7 percent in 2006—largely because several tax cuts will expire on December 31, 2004. Over the following four years, revenues will increase gradually as a share of GDP, reaching 18.2 percent in 2010, CBO projects. After the EGTRRA tax cuts expire at the end of calendar

**Table 1-4.****CBO's Baseline Projections of Mandatory Spending, Including Offsetting Receipts**

(Billions of dollars)

	Actual													Total, 2005-2009	Total, 2005-2014
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2009	2014	
Social Security	470	492	517	538	563	592	624	659	698	741	788	838	2,833	6,556	
Medicare <sup>a</sup>	274	297	324	374	423	452	483	519	562	596	651	706	2,056	5,090	
Medicaid	161	176	182	189	201	219	238	258	281	306	333	362	1,029	2,569	
Income-Support Programs															
Unemployment compensation	55	44	39	38	41	44	46	48	49	51	53	55	208	464	
Supplemental Security Income	33	34	39	37	35	40	42	43	49	42	48	50	192	425	
Earned income and child tax credits	38	42	46	43	42	41	41	41	44	32	32	32	213	394	
Food Stamps	25	28	29	28	27	28	29	29	30	31	32	32	140	294	
Family support <sup>b</sup>	26	25	25	26	26	25	25	25	26	26	26	27	127	257	
Child nutrition	12	12	12	13	14	14	15	15	16	17	17	18	68	151	
Foster care and adoption assistance	6	6	7	7	7	8	8	9	9	9	10	10	37	84	
Subtotal	196	191	196	191	192	200	205	211	223	208	217	224	985	2,068	
Other Retirement and Disability															
Federal civilian <sup>c</sup>	58	61	64	67	70	73	76	80	83	86	90	93	350	782	
Military	36	37	39	41	42	43	45	46	47	49	50	51	210	453	
Veterans' benefits <sup>d</sup>	29	31	35	34	32	34	35	35	38	34	38	38	170	354	
Other	7	7	7	8	8	9	9	10	10	11	11	11	41	94	
Subtotal	129	136	145	149	152	159	165	171	179	180	188	194	770	1,682	
Other Programs															
Commodity Credit Corporation	15	10	10	12	13	14	15	15	15	15	14	14	64	137	
TRICARE for Life	4	5	6	6	7	7	8	8	9	10	10	11	34	82	
Student loans	8	9	5	6	7	7	7	7	7	8	8	8	33	70	
Universal Service Fund	6	6	7	7	7	6	7	7	7	7	7	7	33	69	
State Children's Health Insurance	4	5	5	5	5	5	5	5	5	5	5	5	25	52	
Social services	4	5	5	5	5	5	5	5	5	5	5	5	24	49	
Other	8	25	16	19	18	16	16	16	16	16	15	15	86	164	
Subtotal	50	64	54	60	61	61	63	63	64	66	66	66	298	623	
Offsetting Receipts	-102	-110	-119	-142	-153	-161	-164	-175	-186	-197	-211	-224	-739	-1,731	
<b>Total Mandatory Spending</b>	<b>1,179</b>	<b>1,247</b>	<b>1,299</b>	<b>1,360</b>	<b>1,439</b>	<b>1,522</b>	<b>1,614</b>	<b>1,707</b>	<b>1,822</b>	<b>1,898</b>	<b>2,032</b>	<b>2,165</b>	<b>7,233</b>	<b>16,857</b>	

**Memorandum:**

Mandatory Spending Excluding

Offsetting Receipts

1,281 1,357 1,418 1,501 1,592 1,683 1,778 1,881 2,007 2,096 2,243 2,389 7,972 18,588

Source: Congressional Budget Office.

Note: Spending for the benefit programs shown above generally excludes administrative costs, which are discretionary.

a. Excludes offsetting receipts.

b. Includes Temporary Assistance for Needy Families and various programs that involve payments to states for child support enforcement and family support, child care entitlements, and research to benefit children.

c. Includes Civil Service, Foreign Service, Coast Guard, and other, smaller retirement programs and annuitants' health benefits.

d. Includes veterans' compensation, pensions, and life insurance programs.

**Table 1-5.****CBO's Baseline Projections of Federal Interest and Debt**

(Billions of dollars)

	Actual												Total, 2005-2009	Total, 2005-2014
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014		
<b>Net Interest Outlays</b>														
Interest on Public Debt (Gross interest) <sup>a</sup>	318	322	349	405	460	504	543	579	611	640	665	691	2,261	5,447
<b>Interest Received by Trust Funds</b>														
Social Security	-84	-86	-90	-98	-108	-119	-131	-144	-157	-171	-186	-201	-546	-1,405
Other trust funds <sup>b</sup>	-73	-69	-72	-77	-82	-87	-90	-94	-98	-101	-105	-109	-407	-914
Subtotal	-156	-156	-162	-175	-190	-205	-221	-237	-255	-273	-291	-310	-953	-2,319
Other Interest <sup>c</sup>	-7	-5	-8	-11	-14	-16	-19	-21	-24	-26	-29	-32	-69	-201
Other Investment Income <sup>d</sup>	-2	-3	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-10
<b>Total (Net interest)</b>	<b>153</b>	<b>159</b>	<b>178</b>	<b>217</b>	<b>255</b>	<b>281</b>	<b>302</b>	<b>319</b>	<b>332</b>	<b>340</b>	<b>343</b>	<b>348</b>	<b>1,234</b>	<b>2,917</b>
<b>Federal Debt (At end of year)</b>														
Debt Held by the Public	3,914	4,334	4,694	5,009	5,329	5,660	5,984	6,295	6,506	6,588	6,675	6,753	n.a.	n.a.
<b>Debt Held by Government Accounts</b>														
Social Security	1,484	1,634	1,805	1,995	2,203	2,427	2,665	2,916	3,178	3,449	3,726	4,007	n.a.	n.a.
Other government accounts <sup>b</sup>	1,362	1,425	1,511	1,619	1,724	1,829	1,938	2,051	2,163	2,291	2,414	2,538	n.a.	n.a.
Total	2,846	3,059	3,316	3,614	3,927	4,256	4,603	4,967	5,341	5,740	6,140	6,544	n.a.	n.a.
Gross Federal Debt	6,760	7,393	8,010	8,623	9,257	9,916	10,587	11,261	11,847	12,328	12,815	13,298	n.a.	n.a.
Debt Subject to Limit <sup>e</sup>	6,738	7,370	7,987	8,600	9,234	9,893	10,564	11,237	11,823	12,303	12,790	13,272	n.a.	n.a.
<b>Federal Debt as a Percentage of GDP</b>														
Debt Held by the Public	36.1	37.5	38.2	38.8	39.4	39.9	40.3	40.5	40.1	38.9	37.8	36.6	n.a.	n.a.

Source: Congressional Budget Office.

Note: n.a. = not applicable.

- a. Excludes interest costs of debt issued by agencies other than the Treasury (primarily the Tennessee Valley Authority).
- b. Mainly the Civil Service Retirement, Military Retirement, Medicare, and Unemployment Insurance Trust Funds.
- c. Primarily interest on loans to the public.
- d. Earnings on private investments made by the National Railroad Retirement Investment Trust.
- e. Differs from gross federal debt primarily because most debt issued by agencies other than the Treasury is excluded from the debt limit. The current debt limit is \$7,384 billion.

**Box 1-1.****The Statutory Debt Limit**

The Treasury's authority to issue debt is restricted by a statutory limit, which covers both debt held by the public and the nonmarketable Treasury securities issued to government accounts (such as the Social Security trust funds and the Civil Service Retirement Fund). The current debt limit—which stands at \$7.384 trillion—was enacted on May 27, 2003, in Public Law 108-24. The Congressional Budget Office estimates that under current policies, that limit may be reached in October.

If a new ceiling has not been enacted by the time the current one is reached, the Treasury will be forced to resort to several temporary financing measures to stay under the ceiling until it is raised. Those measures include ceasing to issue certain securities held in the Thrift Savings Plan (a retirement savings and investment plan for federal employees), suspending investments in the Civil Service Retirement Fund, and exchanging Treasury securities with the Federal Financing Bank (a government entity that facilitates federal borrowing and whose securities are not subject to the debt limit). In the most recent debt-limit crises, such measures have permitted the Treasury to remain below the statutory limit for more than three months.

year 2010, revenues will rise sharply again, reaching 19.8 percent of GDP in 2014, the highest level since 2001. Out of the projected increase of 3.6 percentage points in revenues as a share of GDP between 2004 and 2014, about 2.1 percentage points result from the expiration of the tax cuts enacted during the 2001-2003 period.

Individual income taxes are responsible for almost all of the projected rise in revenues as a percentage of GDP over the next 10 years. Receipts from corporate income taxes increase relative to GDP in 2005 and 2006 but then fall back during the rest of the projection period. Other sources of revenue, the largest of which is social insurance taxes, remain relatively stable as a share of GDP.

**Individual Income Tax Receipts.** Relative to the size of the economy, revenues from individual income taxes are expected to be at their lowest level this year since 1951—7.0 percent of GDP. In CBO's baseline, receipts increase in just 10 years from that low to a new high of 10.6 percent of GDP in 2014 (exceeding the previous peak in 2000). That rapid rise results mainly from the expiration of recently enacted tax cuts and several inherent characteristics of the tax structure that increase effective tax rates over time.<sup>8</sup>

Four cuts in individual income taxes are scheduled to expire at the end of calendar year 2004: the expanded 10 percent tax bracket, the higher child tax credit, the expanded 15 percent bracket and standard deduction (intended to provide relief from the so-called marriage penalty), and the increased exemption for the alternative minimum tax (AMT). Those expirations, combined with the cessation of the one-time refunds occurring in 2004 as a result of the tax cuts, explain most of the projected increase in individual income tax receipts as a share of GDP in the next two years.

Over the longer term, however, all of those provisions except the AMT exemption are currently scheduled to phase back in fully by 2010, reducing receipts. In addition, provisions first enacted in 1990 that increase taxes on high-income taxpayers by restricting their itemized deductions and personal exemptions are scheduled to phase out over the 2006-2010 period. At the same time, reduced tax rates on capital gains and dividends that were enacted last year expire at the end of 2008, and all remaining tax cuts (including those phased back in) expire at the end of 2010, boosting receipts in the later years of the projection period.

Furthermore, the effective tax rate on personal income is projected to increase steadily over the next decade because of three factors unrelated to recent changes in tax law.<sup>9</sup> The first factor is the phenomenon known as “real bracket creep”: the dollar amounts that define tax brackets, standard deductions, and personal exemptions are indexed to increase with inflation each year, but when in-

8. For more information, see Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (August 2004).

9. That effective tax rate is the ratio of total individual income taxes paid to total personal income as measured in the national income accounts.

come grows faster than inflation, more income is pushed into higher tax brackets (raising receipts by a total of about 0.7 percent of GDP over the 2005-2014 period).

Second, the parameters of the AMT—a parallel income tax system that has fewer exemptions, deductions, and rates than the regular income tax—are not indexed for inflation. Consequently, over time, a rapidly growing number of taxpayers must pay the AMT and thus pay a higher share of their income in taxes (which increases receipts by more than 0.2 percent of GDP over 10 years).

Third, taxable distributions from tax-deferred retirement accounts—such as 401(k) plans and individual retirement accounts—will increase quickly as a rising number of workers retire from the labor force with, on average, larger balances in their retirement accounts than their predecessors had (raising receipts by about 0.3 percent of GDP).

**Corporate Income Tax Receipts.** Revenues from corporate income taxes are projected to grow from 1.6 percent of GDP this year to 1.9 percent by 2006 and then gradually decline to 1.5 percent by 2014. Both the expiration of corporate tax cuts and the projection of corporate profits relative to GDP contribute to that pattern.

Tax law enacted in 2002 gave businesses an additional first-year depreciation deduction of 30 percent for investments in equipment that year; legislation enacted in 2003 increased the deduction to 50 percent. Because those partial-expensing provisions permit greater up-front deductions for depreciation but do not increase the total amount that can be deducted over the life of the equipment, they only delay tax liability. The provisions benefit both corporate and noncorporate businesses and expire for investments made after 2004. Corporate tax revenues are expected to increase sharply in 2005 and 2006 (and to a lesser degree in the following few years) both because firms will no longer get the additional deductions for new investment and because they will get fewer deductions in those years from previous investments that qualified for the investment incentive.

The relationship between GDP and underlying corporate profits—measured without the effects of the partial-expensing provisions—also influences the projected relationship between corporate tax revenues and GDP. Underlying profits, often referred to as economic profits, have risen much more rapidly than GDP in recent quar-

ters and are expected to remain high through 2005. Thereafter, they are projected to decline as a percentage of GDP because of a larger share of GDP going to labor compensation (as wage growth begins to reflect past productivity gains and higher depreciation associated with strong investment growth). The projected decrease in profits contributes to the outlook for declining corporate receipts as a percentage of GDP beyond 2006.

**Social Insurance and Other Tax Receipts.** Social insurance receipts and other tax receipts are expected to grow at about the same rate as GDP over the next 10 years. Social insurance receipts are largely tied to economywide wages and salaries, which are expected to grow only slightly faster than GDP. Those receipts are projected to increase from 6.3 percent of GDP this year to 6.4 percent in 2005 and 6.5 percent in 2006 and then remain between 6.4 percent and 6.5 percent of GDP through 2014.

As a whole, other revenue sources are projected to stay relatively stable at 1.2 percent to 1.3 percent of GDP over the next decade. Among those sources, excise taxes are expected to decrease from 0.6 percent to 0.5 percent of GDP. Most of those taxes are assessed on the quantity of production or consumption rather than on its price; they therefore grow more slowly than GDP, which includes price increases. Estate and gift taxes are projected to decline from 0.2 percent of GDP now to about 0.1 percent in 2010 and 2011 as the estate tax is phased out under the provisions of EGTRRA. After that, however, estate and gift tax receipts are projected to rebound to 0.3 percent of GDP with the expiration of the tax cuts—and hence the return of the estate tax—after 2010. Earnings of the Federal Reserve System, which are largely generated from its portfolio of Treasury securities, are expected to rise from 0.2 percent of GDP to 0.3 percent over the projection period, mainly because of projected increases in the interest rates on short-term Treasury securities.

## Uncertainty and Baseline Projections

Actual budgetary outcomes are highly sensitive to the performance of the economy and to the myriad variables through which tax and spending policies affect overall economic performance. Uncertainty about the future of those factors translates into uncertainty about the outlook for the budget. Because of that uncertainty, it is informative to characterize the budget outlook not as a

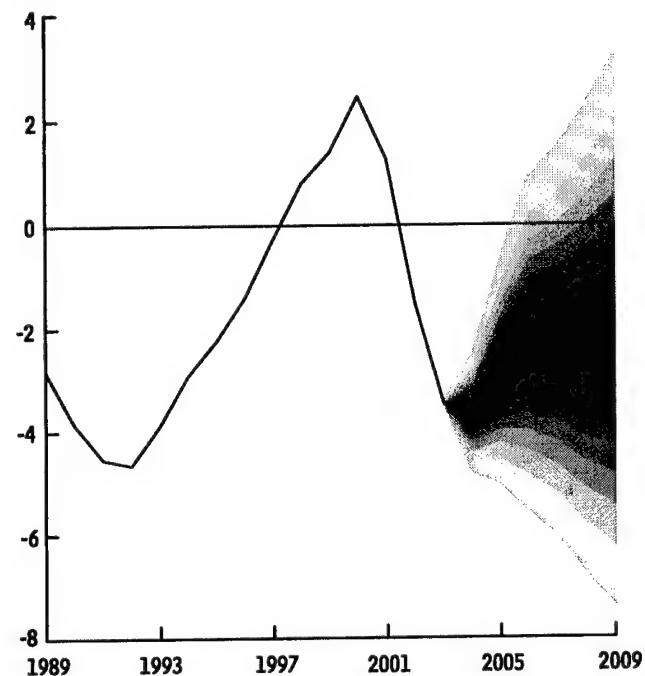
single row of numbers but as a range of possible outcomes centered around those numbers.

Using the difference between past CBO baselines and actual budgetary results as a guide, Figure 1-2 displays a

**Figure 1-2.**

### Uncertainty of CBO's Projections of the Budget Deficit or Surplus Under Current Policies

(Deficit or surplus as a percentage of GDP)



Source: Congressional Budget Office.

Note: This figure, calculated on the basis of CBO's forecasting track record, shows the estimated likelihood of alternative projections of the budget deficit or surplus under current policies. The baseline projections described in this chapter fall in the middle of the darkest area of the figure. Under the assumption that tax and spending policies will not change, the probability is 10 percent that actual deficits or surpluses will fall in the darkest area and 90 percent that they will fall within the whole shaded area.

Actual deficits or surpluses will be affected by legislation enacted in future years, including decisions about discretionary spending. The effects of future legislation are not reflected in this figure.

For an explanation of how CBO typically calculates the probability distribution underlying figures such as this one, see Congressional Budget Office, *The Uncertainty of Budget Projections: A Discussion of Data and Methods* (April 2004).

range of possible outcomes for the total deficit or surplus under current law. The current baseline projection of the deficit falls in the middle of the highest-probability area, shown as the darkest part of the figure. But nearby projections—other paths in the darkest part of the figure—have nearly the same probability of occurring as the baseline projection does. Projections that are increasingly different from the baseline are shown in lighter areas, but they also have a significant probability of coming to pass. For example, CBO projects a deficit of 2.1 percent of GDP for 2009. However, under current law, there is roughly a 10 percent chance that the actual outcome that year will be a deficit greater than 6 percent of GDP, as well as about a 25 percent chance that the budget will be in balance or in surplus.

### Budget Projections Under Alternative Scenarios

CBO's baseline projections—which are founded on current law in order to provide a neutral benchmark for measuring the effects of policy proposals—are likely to be altered in the future by legislative actions. To illustrate the potential effects of different fiscal policies on the baseline, CBO has estimated the budgetary impact of some broad alternative scenarios (see Table 1-6 on page 16). Although the discussion below focuses on the direct effects of those scenarios on revenues and outlays, their full impact would include their effect on debt-service costs (changes in projected interest payments resulting from changes in the government's projected borrowing needs), which is shown separately in Table 1-6.

The future path of discretionary spending has a sizable impact on the budget outlook, but because appropriations are set one year at a time, current policy with regard to future appropriations is undefined. CBO's baseline inflates budget authority for discretionary programs—including supplemental appropriations—from the most recently enacted level and thus projects total discretionary outlays of \$10.8 trillion for the 2005-2014 period. Different assumptions about spending for operations in Iraq and Afghanistan (which have largely been funded through supplemental appropriations thus far) or about the growth rate of regular discretionary appropriations would produce a different total.

If the \$115 billion in supplemental appropriations enacted for 2004 (nearly all for activities in Iraq and Afghanistan) was excluded from the amount extrapolated

for future years, discretionary outlays over the next 10 years would be \$1.1 trillion lower than shown in the baseline. Alternatively, activities in Iraq and Afghanistan could be assumed to slow gradually instead of continuing over the next 10 years at the level funded for 2004. Such a slowdown might involve keeping U.S. force levels related to operations in Iraq and the global war on terrorism at their current levels (about 180,000 active-duty and reserve personnel deployed overseas) through fiscal year 2006 but, over the longer term, reducing U.S. military personnel in Iraq to about 55,000, scaling back operations in Afghanistan to a level comparable with the peace-keeping missions in Bosnia and Kosovo, and decreasing domestic military operations for homeland security. Such a scenario would cost about \$315 billion over the 2005-2014 period—or \$827 billion less in discretionary outlays than shown in the baseline.<sup>10</sup>

Besides scenarios dealing with spending for operations in Iraq and Afghanistan, alternative assumptions about other discretionary spending are possible. For example, if current appropriations (excluding supplementals) were assumed to grow at the same rate as nominal GDP through 2014 instead of at the rate of inflation, total projected discretionary spending would be \$1.2 trillion higher. In the other direction, if appropriations (including supplementals) were frozen at their current level through 2014, with no adjustment for inflation, cumulative discretionary outlays would be \$1.1 trillion lower.

For revenues, CBO's baseline projections rest on the assumption that current tax laws do not change.<sup>11</sup> For example, the baseline envisions that major provisions of EGTRRA—such as the introduction of the 10 percent tax bracket, decreases in previously existing tax rates for individuals, increases in the child tax credit, and the repeal of the estate tax—will expire as scheduled at the end of 2010. On balance, the tax provisions that are set to ex-

pire during the projection period reduce revenues; thus, if they were assumed to be extended, projected revenues would be lower than the level in the baseline.<sup>12</sup> For example, if all expiring tax provisions (except those related to the exemption amount for the AMT) were extended, total revenues over the 2005-2014 period would be nearly \$1.9 trillion lower.

Another policy change that could affect revenues involves modifying the alternative minimum tax, which many observers believe cannot be maintained in its current form. As noted above, the AMT's exemption amount and brackets are not indexed for inflation, which means that its impact will grow in coming years as more taxpayers become subject to the tax (many of whom were not the intended target of the AMT when it was enacted). If the AMT was indexed for inflation after 2004, federal revenues would be \$340 billion lower over the next 10 years, according to CBO and the Joint Committee on Taxation.

## Changes to the Budget Outlook Since March 2004

In the six months since CBO's previous baseline was published, the outlook for the deficit in 2004 and 2005 has improved, but the outlook for the cumulative deficit over the 2005-2014 period has worsened. In March, CBO estimated that this year's deficit would reach \$477 billion, the deficit for 2005 would decline to \$363 billion, and the 10-year deficit would total \$2.0 trillion. In the current baseline, CBO has lowered its estimate for this year's deficit by \$56 billion and for next year's deficit by \$15 billion. However, the total deficit projected for the 2005-2014 period has increased by \$281 billion (see Table 1-7 on page 18).

When CBO revises its baseline projections, it divides the changes into three categories according to their cause: recently enacted legislation, changes to CBO's outlook for the economy, and other, so-called technical factors that affect the budget. Legislative changes to revenues and outlays have worsened the budget's bottom line for the 10-year projection period by \$497 billion. Together, eco-

10. That scenario assumes that budget authority for the 2005-2014 period would total \$351 billion, of which \$27 billion was already provided to the Department of Defense in 2004 as part of the \$28 billion in recently enacted supplemental appropriations. For a discussion of other scenarios, see Congressional Budget Office, *Letter to the Honorable Kent Conrad on the estimated costs of continuing operations in Iraq and other operations of the global war on terrorism* (June 25, 2004).

11. The sole exception involves excise taxes dedicated to trust funds, which, under budget rules, are included in the revenue projections whether or not they are set to expire.

12. In the years before 2011, the largest contributor to the cost of extending those provisions is the depreciation deductions that businesses can take for qualifying investments. Other contributors include the research and experimentation tax credit and two provisions of EGTRRA that were modified by JGTRRA: the child tax credit and the 10 percent tax bracket.

**Table 1-6.****The Budgetary Effects of Policy Alternatives Not Included in CBO's Baseline**

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
<b>Policy Alternatives That Primarily Affect Discretionary Spending for Activities in Iraq and Afghanistan</b>													
Remove the Extension of Supplemental Appropriations from the Baseline After 2004 <sup>a</sup>													
Total discretionary outlays	888	927	908	908	927	946	967	993	1,009	1,037	1,062	4,616	9,685
Effect on the deficit <sup>b</sup>	0	38	92	112	119	123	126	130	131	134	137	484	1,142
Debt service <sup>b</sup>	0	1	4	9	16	23	30	39	47	56	66	52	291
Assume the Slowdown of Such Activities Instead of Extending 2004 Supplemental Appropriations <sup>c</sup>													
Total discretionary outlays	888	946	950	957	972	983	995	1,017	1,033	1,061	1,086	4,808	10,000
Effect on the deficit <sup>b</sup>	0	19	51	63	74	86	98	106	108	111	113	291	827
Debt service <sup>b</sup>	0	*	2	5	9	13	19	25	32	39	47	30	191
<b>Other Policy Alternatives That Affect Discretionary Spending</b>													
Increase Discretionary Appropriations (Except Supplements) at the Growth Rate of Nominal GDP <sup>d</sup>													
Total discretionary outlays	888	975	1,029	1,071	1,122	1,171	1,221	1,277	1,321	1,380	1,437	5,368	12,003
Effect on the deficit <sup>b</sup>	0	-10	-29	-51	-76	-102	-128	-154	-181	-209	-238	-267	-1,176
Debt service <sup>b</sup>	0	*	-1	-3	-7	-12	-18	-26	-36	-48	-62	-23	-212
Freeze Total Discretionary Appropriations at the Most Recently Enacted Level <sup>e</sup>													
Total discretionary outlays	888	955	972	971	974	973	972	975	967	970	970	4,845	9,699
Effect on the deficit <sup>b</sup>	0	10	28	49	72	96	121	148	173	201	229	255	1,128
Debt service <sup>b</sup>	0	*	1	3	6	11	17	25	34	46	59	22	203

**Continued**

conomic and technical changes have partially offset that effect, improving the projected bottom line by \$216 billion for the same period.<sup>13</sup>

13. The categorization of revisions should be interpreted with caution. For example, legislative changes represent CBO's best estimates of the future effects of laws enacted since the previous baseline. If a new law proves to have different effects from the ones in CBO's initial estimate, the differences will appear as technical reestimates in later revisions to the baseline. The distinction between economic and technical revisions is similarly imprecise. CBO classifies economic changes as those resulting directly from changes in the components of its economic forecast (interest rates, inflation, GDP growth, and so on). Changes in other factors related to the performance of the economy (such as the amount of capital gains realizations and the relative income growth of higher- and lower-income taxpayers) are shown as technical reestimates.

CBO's revenue projections have increased by \$54 billion for 2004 and by \$322 billion for the 2005-2014 period. Economic revisions have increased revenues over that period by a total of \$361 billion, whereas legislation enacted since March and technical changes have together lowered projected revenues by \$39 billion.

Projected outlays have decreased slightly for 2004 but have grown by a total of \$603 billion (including debt-service costs) for the following 10 years. Most of that increase, \$492 billion, stems from newly enacted legislation—principally from extrapolating the \$28 billion in recent supplemental appropriations for 2004 and the Department of Defense's appropriations for 2005. Changes in CBO's economic assumptions add another \$188 bil-

**Table 1-6.****Continued**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
<b>Policy Alternatives That Affect the Tax Code</b>													
<b>Extend Expiring Tax Provisions<sup>f</sup></b>													
Effect on the deficit <sup>b</sup>													
EGTRRA and JGTRRA	0	-13	-33	-35	-34	-42	-39	-175	-280	-292	-306	-157	-1,249
Partial expensing	0	-38	-71	-66	-58	-48	-40	-33	-28	-26	-28	-281	-437
Other	0	-6	-6	-10	-14	-16	-19	-23	-28	-31	-34	-53	-188
Total	0	-58	-110	-112	-106	-106	-98	-231	-336	-348	-369	-491	-1,874
Debt service <sup>b</sup>	0	-1	-5	-11	-18	-24	-30	-40	-57	-77	-100	-58	-363
<b>Reform the Alternative Minimum Tax<sup>g</sup></b>													
Effect on the deficit <sup>b</sup>	0	-7	-20	-27	-36	-46	-56	-47	-27	-33	-40	-136	-340
Debt service <sup>b</sup>	0	*	-1	-2	-4	-6	-9	-12	-15	-17	-20	-13	-85
<b>Memorandum:</b>													
Total Discretionary Outlays in CBO's Baseline	888	965	1,000	1,020	1,046	1,069	1,093	1,123	1,140	1,172	1,199	5,100	10,827
Total Deficit in CBO's Baseline	-422	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-1,584	-2,294

Sources: Congressional Budget Office; Joint Committee on Taxation.

Note: \* = between -\$500 million and \$500 million; EGTRRA = Economic Growth and Tax Relief Reconciliation Act of 2001; JGTRRA = Jobs and Growth Tax Relief Reconciliation Act of 2003.

- a. This alternative does not extend the \$115 billion in supplemental appropriations enacted during fiscal year 2004 (\$87 billion in November and \$28 billion in August) but includes the outlays resulting from them.
- b. Positive amounts indicate a decrease in the deficit; negative amounts indicate an increase.
- c. This alternative does not extend the \$115 billion in supplemental appropriations enacted during 2004; however, it assumes that about \$56 billion in budget authority would be needed in 2005 to maintain activities related to Iraq and Afghanistan (nearly \$27 billion of which was already made available in 2004). After 2006, that amount of resources begins to decline to a level of about \$23 billion per year. See Congressional Budget Office, *Letter to the Honorable Kent Conrad on the estimated costs of continuing operations in Iraq and other operations of the global war on terrorism* (June 25, 2004) for similar calculations.
- d. This alternative assumes that the supplemental appropriations enacted during 2004 are projected at baseline levels.
- e. This alternative assumes that regular appropriations for defense are frozen at the 2005 level and that all other appropriations (including 2004 supplementals) are frozen at the level provided for 2004.
- f. This alternative does not include the effects of extending the increased exemption amount for the alternative minimum tax, which expires in 2004. The effects of that alternative are shown below.
- g. This alternative assumes that the exemption amount for the AMT, which was increased through 2004 in the Jobs and Growth Tax Relief Reconciliation Act of 2003, is extended at its higher level and, together with the AMT tax brackets, is indexed for inflation after 2004. The estimates are shown relative to current law. If this alternative was enacted jointly with the extension of expiring tax provisions, an interactive effect would occur that would make the combined revenue loss greater than the sum of the two separate estimates by about \$160 billion (plus \$17 billion in debt-service costs) over the 2005-2014 period.

**Table 1-7.****Changes in CBO's Baseline Projections of the Deficit Since March 2004**

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
Total Deficit as Projected in March 2004	-477	-363	-273	-274	-286	-281	-272	-176	-38	-34	-15	-1,477	-2,012
Changes to Revenue Projections													
Legislative	3	6	1	-1	-1	-2	-3	-2	-1	-1	-1	3	-5
Economic	14	29	31	33	35	41	43	44	40	35	30	169	361
Technical	37	10	-9	-10	-8	-8	-4	*	-2	-2	-2	-25	-34
Total Revenue Changes	54	44	24	22	26	31	36	42	37	32	28	147	322
Changes to Outlay Projections													
Legislative													
Discretionary													
Defense	*	26	34	36	37	37	38	39	39	40	41	170	367
Nondefense	*	2	2	2	2	2	2	2	2	2	2	10	20
Subtotal, discretionary	*	28	36	38	38	39	40	41	41	42	43	180	387
Mandatory	*	*	*	*	*	*	*	*	*	*	*	1	1
Net interest (Debt service)	*	*	2	4	6	8	11	14	17	20	23	20	104
Subtotal, legislative	1	29	38	42	45	48	51	54	58	62	66	201	492
Economic													
Discretionary	0	3	8	10	10	9	9	8	8	7	7	40	79
Mandatory													
Social Security	0	5	6	7	8	9	10	12	14	16	18	34	104
Medicaid	*	1	2	3	3	4	5	6	7	8	9	12	46
Other	-3	-1	1	1	1	2	2	2	2	2	2	4	15
Subtotal, mandatory	-2	5	10	11	12	14	17	20	23	26	29	51	165
Net interest													
Debt service	*	-1	-2	-3	-4	-5	-6	-7	-8	-9	-9	-14	-53
Rate effect/inflation	2	-2	-1	*	-1	*	*	*	*	*	*	-3	-3
Subtotal, net interest	2	-3	-2	-2	-4	-5	-6	-7	-8	-9	-9	-17	-56
Subtotal, economic	*	5	15	18	18	18	19	21	22	24	27	74	188

Continued

lion to projected 10-year outlays, primarily for components that are sensitive to changes in inflation (such as projections of discretionary spending and of Social Security's cost-of-living adjustments). Technical changes partially offset the legislative and economic changes, lowering projected spending for the 10-year period by \$77 billion.

**The Effects of Recent Legislation**

Laws enacted in the past six months have decreased this year's deficit by \$3 billion but worsened the budgetary picture for the 2005-2014 period by \$497 billion. Virtually all of that 10-year change comes from revisions to the projections of outlays.

**Table 1-7.****Continued**

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Total, 2005-2009	Total, 2005-2014
<b>Technical</b>													
Discretionary	-8	-2	1	*	*	*	*	*	*	*	*	-2	-3
Mandatory													
Social Security	-1	-1	-1	-2	-3	-3	-4	-5	-5	-6	-7	-10	-37
Farm programs (CCC)	-3	-2	-2	-2	-1	*	*	*	*	*	*	-7	-8
Medicaid	2	1	1	*	*	*	*	*	*	*	*	2	4
Sept. 11 victim compensation	3	-2	*	0	0	0	0	0	0	0	0	-2	-2
Other	2	1	1	2	2	2	*	*	1	1	1	8	11
Subtotal, mandatory	4	-3	-2	-1	-1	-2	-4	-4	-4	-5	-6	-9	-33
Net interest													
Debt service	*	-1	-2	-2	-2	-2	-2	-2	-3	-3	-4	-8	-21
Other	2	2	*	-1	-1	-1	-2	-3	-4	-4	-5	-2	-20
Subtotal, net interest	1	*	-2	-3	-3	-3	-4	-5	-6	-7	-9	-10	-41
Subtotal, technical	-2	-4	-4	-4	-4	-5	-8	-9	-11	-13	-15	-21	-77
<b>Total Outlay Changes</b>	<b>-2</b>	<b>29</b>	<b>49</b>	<b>56</b>	<b>59</b>	<b>61</b>	<b>62</b>	<b>66</b>	<b>70</b>	<b>73</b>	<b>78</b>	<b>254</b>	<b>603</b>
<b>Total Impact on the Deficit</b>	<b>56</b>	<b>15</b>	<b>-26</b>	<b>-34</b>	<b>-32</b>	<b>-31</b>	<b>-26</b>	<b>-24</b>	<b>-33</b>	<b>-41</b>	<b>-50</b>	<b>-107</b>	<b>-281</b>
Total Deficit as Projected in September 2004	-422	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65	-1,584	-2,294
<b>Memorandum:</b>													
Total Legislative Changes	3	-23	-37	-43	-46	-50	-54	-56	-59	-63	-67	-198	-497
Total Economic Changes	14	24	16	15	18	23	23	23	18	10	4	95	173
Total Technical Changes	39	15	-5	-6	-4	-3	5	9	9	11	13	-4	43

Source: Congressional Budget Office.

Note: \* = between -\$500 million and \$500 million; CCC = Commodity Credit Corporation.

**Discretionary Spending.** The Department of Defense Appropriations Act, 2005 (Public Law 108-287) accounts for all of the legislative changes to projected discretionary outlays. The law provides \$391 billion in budget authority for defense for 2005—\$9 billion more than CBO’s March baseline had assumed by adjusting enacted 2004 budget authority for inflation. That increase in budget authority causes projected outlays for 2005 to rise by \$7 billion. Extended over the 2005–2014 period, it adds \$97 billion to the baseline for discretionary outlays.

P.L. 108-287 also provides \$28 billion in supplemental budget authority for 2004, nearly \$27 billion of which is designated for costs directly associated with operations in Iraq and Afghanistan. Although that funding was made

available upon enactment and thus is counted as 2004 budget authority, the Administration will not disburse most of the funds until 2005. As a result, the new funding has a negligible effect on 2004 outlays but increases estimated 2005 outlays by \$19 billion. Extrapolating that additional supplemental funding boosts projected discretionary defense spending over the 2005–2014 period by another \$270 billion.

For nondefense programs, P.L. 108-287 provides authority to fund highway projects as well as \$1 billion in supplemental 2004 budget authority for a variety of programs, primarily in the Departments of State and Agriculture. Extrapolating those changes to nondefense programs increases outlays by \$2 billion for 2005 and by a total of \$20 billion through 2014.

**Mandatory Spending.** Legislation enacted since March has had little budgetary effect on mandatory programs, increasing their projected spending by just \$1 billion over 10 years.

**Revenues.** Changes in law in the past six months have played only a minor role in revisions to the revenue projections. (As described below, economic changes have had a far greater impact.) CBO and the Joint Committee on Taxation estimate that laws enacted since March will increase receipts this year by \$3 billion and reduce them over the 2005-2014 period by about \$5 billion.

The Pension Funding Equity Act of 2003 (P.L. 108-218) has had the largest legislative impact. It allows firms to use higher interest rates through 2005 to calculate their pension liabilities, resulting in smaller tax-deductible pension contributions and an estimated \$10 billion in additional revenues over the 2004-2006 period. Revenues are expected to decline by a similar amount from 2007 through 2014 when employers increase their contributions to compensate for the lower ones they made in 2004 and 2005.

Recently enacted trade legislation has reduced the revenues projected for the 2005-2014 period by an estimated \$1.4 billion. Lawmakers have enacted free-trade agreements with Australia and Morocco, further liberalized trade with sub-Saharan Africa, and renewed for one year the ban on trade with Burma, all of which act to reduce customs duties.

**Net Interest.** In all, the legislation enacted in the past six months will increase the cumulative deficit for the 2005-2014 period by \$393 billion, CBO estimates. That increase adds \$104 billion to projected debt-service costs over those 10 years (for the total legislative impact of \$497 billion).

### The Effects of Economic Changes

Changes in the outlook for the economy since January—when CBO last updated its economic projections—reduce this year's projected deficit by \$14 billion, almost entirely on the revenue side of the budget. For the 2005-2014 period, economic revisions increase projected revenues by \$361 billion and projected outlays by \$188 billion relative to CBO's March baseline, thus reducing the cumulative deficit by \$173 billion. The major economic changes causing those revisions are slightly higher projected levels of GDP and wages and higher projected in-

flation in the near term. (CBO's new economic forecast and projections are described in Chapter 2.)

**Discretionary Spending.** As noted above, CBO is required to project discretionary budget authority using two measures of inflation: the GDP deflator (which covers the changes in price of all goods and services contributing to GDP) and the employment cost index for wages and salaries. CBO's forecast for both measures over the 2004-2006 period has increased, but its projection for the GDP deflator from 2007 through 2014 has declined slightly. Despite that slower growth after 2006, the projected level of the GDP deflator remains above the level anticipated in January because of more-rapid growth in 2004 and 2005. Overall, those changes raise projected discretionary outlays over the 2005-2014 period by a total of \$79 billion.

**Mandatory Spending.** The effect of economic changes has been much greater on mandatory spending. Updates to CBO's economic forecast since January have added \$165 billion to projected mandatory outlays for the 2005-2014 period.

Social Security and Medicaid are the two mandatory programs most affected by the revised economic forecast. Higher projected inflation in 2004 boosts the upcoming cost-of-living adjustment for Social Security beneficiaries by 1.2 percentage points, which will raise projected Social Security payments each year. In addition, higher projected wage growth increases future benefit payments. In all, such economic changes increase the outlay projections for Social Security by \$104 billion through 2014. Higher projected inflation in health care costs has a similar effect on Medicaid over the decade, raising projected outlays for that program by a total of \$46 billion from the level in the March baseline.

**Revenues.** Except in 2004, most of the change since March in CBO's revenue projections comes from changes in the economic outlook. Economic reestimates add about \$14 billion to revenues this year and \$361 billion—about 1.3 percent—for the 2005-2014 period.

CBO has increased its projection of nominal GDP, mainly because of higher expected inflation in 2004 and 2005 and slightly higher expected real growth beyond 2005. That revised outlook has caused CBO to raise its projection of payments for wages and salaries, the type of income subject to the highest marginal tax rate. As a re-

sult, CBO has increased its projections for both individual income and social insurance taxes, accounting for nearly all of the upward revision to revenues for the 2005-2014 period.

In recent quarters, corporate profits have been stronger than CBO expected in January. The resulting changes in CBO's outlook for profits contribute to the upward reestimate to revenues for the next two years. Beyond 2006, CBO has not revised its projections of book or economic profits significantly, although reductions in the share of those profits earned domestically reduce tax receipts and offset the upward reestimate in the near term.

**Net Interest.** Economic revisions to projected net interest spending have two components: the effects of changes in interest rates and inflation and the effects of additional (or reduced) debt service. Recent increases in inflation have raised interest costs on TIPS by more than \$2 billion this year. In the other direction, a lower forecast for short-term interest rates in 2005 and 2006 helps reduce projected spending on net interest over the 2005-2014 period by \$3 billion. (CBO has lowered its estimate of the interest rate on three-month Treasury bills by 0.32 percentage points for 2005 and by 0.5 percentage points for the first quarter of fiscal year 2006.) In addition, CBO projects that the debt-service savings associated with economic changes total about \$53 billion through 2014.

### The Effects of Technical Changes

Technical changes represent all other revisions to the baseline not directly related to recent laws or to changes in the economic outlook. For 2004, technical changes decrease the projected deficit by \$39 billion—almost entirely because of upward revisions to revenue estimates. For the 2005-2014 period, technical changes lower the cumulative deficit by \$43 billion.

**Discretionary Spending.** Technical reestimates reduce projected discretionary outlays in 2004 by \$8 billion; those changes chiefly reflect new information about spending so far this year. For the following 10 years, a variety of technical adjustments lower projected discretionary spending by a total of \$3 billion.

Although those technical revisions affect nearly all areas of the budget, the largest involve the Iraq Relief and Reconstruction Fund. CBO has reduced its estimate of outlays from that fund by \$2.4 billion for 2004 and \$2.3

billion for 2005 to reflect the unexpectedly slow rate of spending thus far. In addition, CBO's estimate of transportation spending this year has declined by \$1.0 billion, and its estimate of outlays for grants for elementary and secondary education has dropped by \$1.5 billion.

**Mandatory Spending.** Technical adjustments increase CBO's projection of mandatory spending for 2004 by \$4 billion relative to the previous baseline. For the 2005-2014 period, such adjustments reduce projected mandatory spending by \$33 billion, with most of that decline resulting from relatively small revisions to projections of Social Security benefits.

The bulk of CBO's technical reestimates for Social Security stem from adopting new assumptions about population projections. In the Social Security trustees' 2004 report, historical population figures were revised, and the projected population of the "Social Security area" (which includes the United States, Puerto Rico, and overseas military personnel) was lowered by between 3 million and 4 million each year. Roughly one-fifth of that net revision reflects the population age 62 and older. As a result, CBO has lowered its estimates of Social Security benefits by amounts that grow to \$7 billion in 2014.

Projected spending for farm price-support and income-support payments by the Commodity Credit Corporation over the 2005-2014 period has declined by \$8 billion since the March baseline. Most of that reduction affects the first few years of the projection period; it stems from new information about the number of producers receiving program benefits and the current high prices for many agricultural commodities.

CBO's estimate for Medicaid spending this year has grown by \$2 billion on the basis of spending through July. Technical changes have little effect, however, on the longer-term projections for Medicaid outlays.

Estimated 2004 outlays from the September 11th Victim Compensation Fund have increased by \$3 billion, primarily because CBO now expects the remaining payments from the fund to be made in 2004 rather than spread over 2005 and 2006. In addition, the average payment per recipient for cases involving a death is projected to increase slightly from what CBO estimated in March. The fund has also paid more disability claims than CBO anticipated.

Other technical changes to mandatory programs include an increase of \$4.3 billion for student loans in 2004 because of a higher-than-expected volume of loan consolidations. In addition, CBO has reduced its projections of spending for unemployment benefits by \$1.0 billion for 2004, \$1.6 billion for 2005, and \$1.3 billion for 2006. Those changes reflect a lower-than-expected number of claims this year, partly offset by a longer-than-anticipated average duration of benefits.

**Revenues.** CBO has increased its revenue projections by \$37 billion for 2004 and \$10 billion for 2005 and decreased them by a total of \$44 billion for the rest of the projection period for reasons other than changes in the economic projections or legislation enacted since March. Three factors explain most of those technical reestimates: recent information about tax collections, new data on the effects of the partial-expensing provisions enacted in 2002 and 2003, and new modeling of the effects of corporate losses on future tax receipts.

First, collections of individual and corporate income taxes have been higher this year than CBO projected in March. Stronger-than-expected incomes (as currently measured in the national income and product accounts) and recent legislation explain only part of that strength. The other causes will become more apparent once individual and corporate income tax returns for 2003 and 2004 are available for study.

In the meantime, CBO must infer the reasons for the additional tax revenues and project their likely path. On the basis of its experience with such deviations and the cyclical nature of several of the possible causes, CBO assumes that the unexplained increase in revenues in 2004 will gradually dissipate in the next several years—more quickly for corporate receipts, which are highly cyclical, than for individual income tax receipts. In CBO's baseline, most of the unexplained receipts are phased out by 2007. In all, CBO has raised its revenue projections by almost \$70 billion for 2004 through 2009 because of those factors.

Second, data from corporate income tax returns for 2002 indicate that firms utilized the new partial-expensing provisions by about 30 percent less than CBO had anticipated. CBO now estimates that those provisions will reduce revenues by about \$10 billion less over the 2004-

2005 period than previously expected and increase revenues by about \$30 billion less thereafter.

Third, CBO has adjusted its modeling of corporations' losses, which are especially important following the decline in profits in 2001 and the large increases that year in the amount of losses by unprofitable firms. Companies can use losses from unprofitable years to reduce taxable profits up to 20 years later. CBO now anticipates that more losses will be generated and used in future years than it previously expected, reducing projected receipts over the 2004-2014 period by more than \$50 billion.

One technical change to revenue projections results only in a reallocation of 2004 revenues between social insurance and individual income taxes, without changing overall receipts. CBO has reduced its projection of social insurance receipts by about \$17 billion and increased estimated individual income taxes by the same amount to reflect official data as reported in the *Monthly Treasury Statement*. When employers remit taxes withheld from paychecks to the Internal Revenue Service, they do not specify how much represents individual income taxes and how much represents payroll taxes for the Hospital Insurance and the Old-Age, Survivors, and Disability Insurance programs. The Treasury Department estimates those components and then corrects its earlier estimates in later years once data from tax returns become available. The corrections in 2004 have been larger than usual. However, they do not affect CBO's projections beyond this year.

**Net Interest.** Technical reestimates lower projected outlays for net interest (other than debt service) over the 2005-2014 period by \$20 billion. In particular, CBO has revised its assumptions about the future composition of debt held by the public, assuming that more TIPS and fewer bills and notes will be issued than it estimated in March. That assumption reflects the change in the Treasury's auction calendar that introduced 20-year and five-year TIPS.

Overall, technical changes to the baseline reduce revenues by \$34 billion and outlays by \$56 billion over the projection period. The resulting decline in the cumulative deficit decreases projected debt-service costs through 2014 by \$21 billion.

## 2

## The Economic Outlook

**T**he Congressional Budget Office expects solid growth in overall economic output over the next two years. Overall demand is now rising fast enough to spur producers to expand their productive capacity by investing in new capital (equipment and structures) and hiring more workers. As a result, the economy has passed into a more balanced stage of growth than that immediately following the 2001 recession. During the rest of calendar year 2004 and in 2005, large gains in investment by businesses are likely to lead that expansion. CBO forecasts that real (inflation-adjusted) gross domestic product will expand by 4.5 percent in 2004 and 4.1 percent in 2005 and then grow at an average annual rate of 2.8 percent over the medium term—from 2006 to 2014. Over the entire 2004–2014 period, growth is expected to average 0.1 percentage point more than in CBO’s January 2004 forecast.

At present, the productive capacity of the economy is not being fully employed. Unusually large gains in productivity allowed real GDP to expand rapidly over the past year without taking up much of the “slack”—underutilized labor and capital—that developed in the 2001 recession and its slow-growth aftermath in 2002 and early 2003. But if productivity growth settles into a more moderate pace in the future, as it is expected to do, the rapid expansion of GDP that CBO forecasts for the near term will eliminate any remaining underused capacity in the economy by the end of 2005. The removal of that slack would be accompanied by a reduction in the unemployment rate and a rise in interest rates. Inflation, by comparison, would probably remain modest; CBO views some of the pickup in inflation earlier this year as temporary.

A variety of factors could produce outcomes that differed from CBO’s best estimates of the economic conditions likely to prevail over the next two years. Further increases in oil prices would reduce real consumer incomes and worsen the trade balance, although they would be un-

likely to derail the recovery. A loss of confidence by businesses or investors because of those higher oil prices or some other adverse factor could result in less investment by businesses than CBO expects. A decline in foreigners’ demand for U.S. assets that led to an abrupt drop in the dollar could have mixed effects, ultimately helping net exports but hurting interest-sensitive sectors of the economy such as housing (by raising interest rates) and producing temporarily higher inflation (by boosting prices for imports). A large drop in the prices of homes in some regions of the country could hold down consumer spending, and growth in foreign economies that was weaker than expected would hurt exports, slowing the growth of GDP. Yet many of those factors could also improve more than CBO expects, which would lead to an even stronger two-year outlook.

Over the medium term, the factor that most affects the accuracy of CBO’s projections is the rate of growth of productivity. That growth could remain unusually fast-paced, adding to the expansion of output, or it could drop to below-average rates, causing the growth of GDP to be slower than CBO anticipates.

### Overview of the Outlook

In CBO’s estimation, the economy has entered a phase of investment-led growth in which the number of jobs is rising and real GDP is expanding faster than its trend rate. Indeed, CBO expects real GDP to grow so strongly during 2004 and 2005 that the current excess capacity in the economy will be eliminated by the end of 2005 (see Table 2-1). But whether that expectation is fulfilled depends in large part on how lasting the recent surge in productivity turns out to be. The amount of slack that remains in the economy, and thus the room it has for growth before excess capacity is eliminated, are highly uncertain (see Box 2-1 on page 28). Overall, however, CBO’s forecast is similar to the one published in its January 2004 report *The Budget and Economic Outlook: Fiscal Years 2005 to 2014*;

**Table 2-1.****CBO's Economic Projections for Calendar Years 2004 Through 2014**

	Actual 2003	Forecast		Projected Annual Average	
		2004	2005	2006-2009	2010-2014
<b>Nominal GDP</b>					
In billions of dollars	11,004	11,753	12,464	15,016 <sup>a</sup>	18,628 <sup>b</sup>
As a percentage change	4.9	6.8	6.1	4.8	4.4
Real GDP (Percentage change)	3.0	4.5	4.1	3.0	2.6
GDP Price Index (Percentage change)	1.8	2.2	1.8	1.7	1.8
Consumer Price Index <sup>c</sup> (Percentage change)	2.3	2.6	2.0	2.2	2.2
Unemployment Rate (Percent)	6.0	5.6	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.0	1.3	2.6	4.5	4.6
Ten-Year Treasury Note Rate (Percent)	4.0	4.6	5.4	5.5	5.5
<b>Tax Bases (Percentage of GDP)</b>					
Corporate book profits	7.9	8.9	11.7	10.0	9.1
Wages and salaries	46.4	45.7	45.8	46.1	46.1
<b>Tax Bases (Billions of dollars)</b>					
Corporate book profits	874	1,045	1,455	1,411 <sup>a</sup>	1,710 <sup>b</sup>
Wages and salaries	5,104	5,370	5,703	6,924 <sup>a</sup>	8,592 <sup>b</sup>

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year. Year-by-year economic projections for calendar and fiscal years 2004 through 2014 appear in Appendix C.

- a. Level in 2009.
- b. Level in 2014.
- c. The consumer price index for all urban consumers.

the only significant change since then is that CBO now foresees a more rapid rise in inflation.

CBO does not attempt to forecast the ups and downs of the business cycle after 2005. Instead, its medium-term projection (through 2014) reflects where GDP is likely to be, on average, during future cycles. As a result, CBO's projection of the growth of GDP keeps pace roughly with its estimate of the trend growth of the economy—that is, potential GDP.<sup>1</sup> Real GDP growth will average 3.0 percent from 2006 to 2009 and 2.6 percent from 2010 to 2014, CBO estimates. The slower growth projected for the latter half of the period stems primarily from slower

growth of the labor force, as the baby boomers begin to retire.

CBO's forecast incorporates the likely macroeconomic effects of baseline fiscal policy. In particular, it takes into account the impact of portions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003, including the laws' influence on the supply of labor hours and saving.<sup>2</sup> One of the assumptions on which CBO's

1. Potential GDP is the level of real gross domestic product that corresponds to a high level of use of resources (labor and capital).

2. For an analysis of EGTRRA's likely effects on the economy over the medium term, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2001), Box 2-3. For an analysis of JGTRRA's likely economic effects over the medium term, see Congressional Budget Office, *The Budget and Economic Outlook: An Update* (August 2003), Box 2-3.

estimates of such effects rests is that businesses and households will behave as if they believed that the “sunsets” (scheduled expirations of tax cuts) contained in EGTRRA would, indeed, occur. CBO’s forecast also incorporates the revisions to the national income and product accounts (NIPAs) published in July 2004.

The rate of unemployment in CBO’s two-year forecast and medium-term projection is related to CBO’s estimate of the gap between GDP and potential GDP. As that gap closes over the next two years, CBO expects the unemployment rate to fall to 5.6 percent in 2004 and 5.2 percent in 2005. The rate will then average 5.2 percent from 2006 to 2014, in CBO’s estimation.

Inflation will rise at a faster pace in 2004 than in 2003, CBO forecasts, primarily as a result of more rapid growth in core prices earlier this year. (Core prices exclude food and energy.) Yet even after the acceleration in inflation thus far in 2004, price increases remain low by post-World War II standards. For 2005, inflation is projected to ease somewhat, as energy prices first fall and then grow at more normal rates. Consumer price inflation, according to CBO’s two-year estimates, will rise from 2.3 percent in 2003 to 2.6 percent in 2004 but then fall to 2.0 percent in 2005. CBO projects that consumer prices will increase at an average annual rate of 2.2 percent from 2006 to 2014.

Interest rates, especially short-term interest rates, are expected to climb as the economy continues to grow, but they are also likely to remain low by historical standards. The interest rate on three-month Treasury bills is forecast to increase from an average of just 1.0 percent in 2003 to 1.3 percent in 2004 and 2.6 percent in 2005; it is then expected to average 4.5 percent from 2006 to 2014. Yields on 10-year Treasury notes will rise by a smaller cumulative amount, CBO expects, from an average of 4.0 percent in 2003 to 4.6 percent in 2004, 5.4 percent in 2005, and 5.5 percent, on average, from 2006 to 2014.

In CBO’s forecast, both fiscal and monetary policy shift course during 2004 and 2005 relative to their paths in recent years. As projected under current law, the effect of fiscal policy on the short-term growth of demand in 2004 will be more modest than it was in 2003; in 2005, it will restrain such growth. The additional demand in 2004 derives from JGTRRA as well as from an increase in defense spending. In 2005, the expiration of certain provisions of

JGTRRA and smaller refunds of personal taxes (the taxes on income received by individuals) are expected to reverse some of the fiscal policy influence present in 2004. Similarly, growth in private-sector demand is likely to permit the unusually easy stance of current monetary policy to gradually give way to a more neutral posture during 2004 and 2005.<sup>3</sup>

## CBO’s Two-Year Forecast

In CBO’s outlook for 2004 and 2005, the economy remains in the current phase of its cyclical expansion (see Table 2-2). That phase is characterized by a self-reinforcing cycle of healthy growth in demand and a corresponding need for businesses to employ more workers and capital—which in turn fuels more demand. In the two-year forecast, interest rates rise gradually from their unusually low current levels. Inflation, however, after temporarily climbing in 2004, is forecast to recede, growing slightly more slowly in 2005 than in 2003.

## The Labor Market

After more than two years of sustained losses in payroll employment, the labor market has begun to rebound and by so doing provide the underpinnings of further growth. From 2001 to 2003, firms more than met the slow growth of demand for goods and services by gains in productivity, which allowed them to let go of more workers than they hired. As a result, the number of nonfarm payroll employees fell by 2.7 million between its peak in March 2001 and August 2003 (see Figure 2-1). Since last August, firms have added to their workforces as the growth of demand accelerated. The number of nonfarm workers rose by about 500,000 between August 2003 and February 2004, and by another 1.0 million between February 2004 and July 2004.

Those changes in employment were also reflected in the unemployment rate, which rose from 4.3 percent in March 2001 to a peak of 6.3 percent in June 2003. The rise would have been larger but for the fall in the rate of labor force participation—from 67.1 percent to 66.5 per-

3. A “neutral” monetary policy is a level of short-term interest rates and a rate of growth of the money supply that sustains economic growth while maintaining low inflation. An “easy” monetary policy suggests initially lower short-term interest rates and faster growth of the money supply in an attempt to increase aggregate demand—but it may lead to higher inflation.

**Table 2-2.****CBO's Economic Forecast for 2004 and 2005**

	Actual	Forecast	
	2003	2004	2005
<b>Calendar Year Average</b>			
Real GDP (Percentage change)	3.0	4.5	4.1
Unemployment Rate (Percent)	6.0	5.6	5.2
Three-Month Treasury Bill Rate (Percent)	1.0	1.3	2.6
Ten-Year Treasury Note Rate (Percent)	4.0	4.6	5.4
<b>Fourth Quarter to Fourth Quarter (Percentage change)</b>			
Nominal GDP	6.2	6.9	5.3
Real GDP	4.4	4.3	3.6
GDP Price Index	1.7	2.4	1.6
Consumer Price Index			
Overall	1.9	3.0	1.8
Excluding food and energy	1.2	2.2	2.1

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

cent—over the same period.<sup>4</sup> As businesses expanded their workforces during the past year, the unemployment rate fell to 5.5 percent in July 2004—although the rate of labor force participation also dropped, to 66.2 percent, in that month. The additional fall in the participation rate since mid-2003 means that the decline in the unemployment rate does not fully reflect the overall condition of the labor market.

With the growth of overall demand likely to continue outpacing the growth of potential GDP over the next two years, businesses will add workers to meet that extra demand, CBO forecasts. As a result, employment will grow at above-average rates, and the unemployment rate will fall from 6.0 percent in 2003 to 5.6 percent in 2004 and 5.2 percent in 2005. That decline in the unemployment rate will be tempered, in CBO's view, by a rebound in labor force participation (since many new jobs will be taken by people who are not currently in the labor force).

4. The rate of labor force participation is measured as the share of the population ages 16 and older who are either employed or actively looking for work.

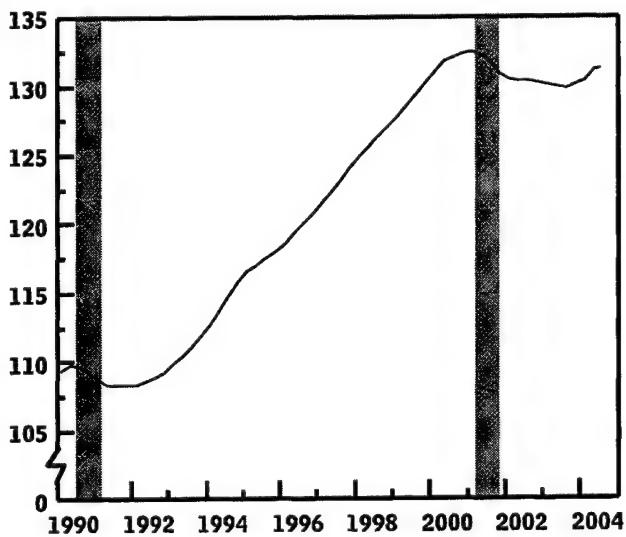
**The Growth of Demand**

The same factor that is now spurring a rise in employment—the need to add productive resources to satisfy more demand—will also lead businesses to purchase new structures and equipment and to rebuild their inventories. As a result, growth in the economy during the rest of 2004 and in 2005 will be led by businesses' investment—the sector that declined the most during the 2001 recession and its aftermath. That growth continues a pattern: over the last two business cycles, investment by the private sector, including residential construction, has accounted for most of the movement in output as a percentage of potential GDP (see Figure 2-2).

In previous business cycles, the contributions to growth made by other components of GDP rose and fell. However, since the late 1980s, the sum of those components has stayed roughly flat relative to potential GDP, and CBO expects that pattern to continue through 2005, with those components together growing at about the same rate as potential GDP. Personal consumption is likely to rise at a healthy pace but not as fast as GDP, in CBO's estimation. Exports are expected to contribute to the expansion, aided by robust growth in many overseas economies and a continued depreciation of the dollar. At

**Figure 2-1.****Nonfarm Payroll Employment**

(Millions)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

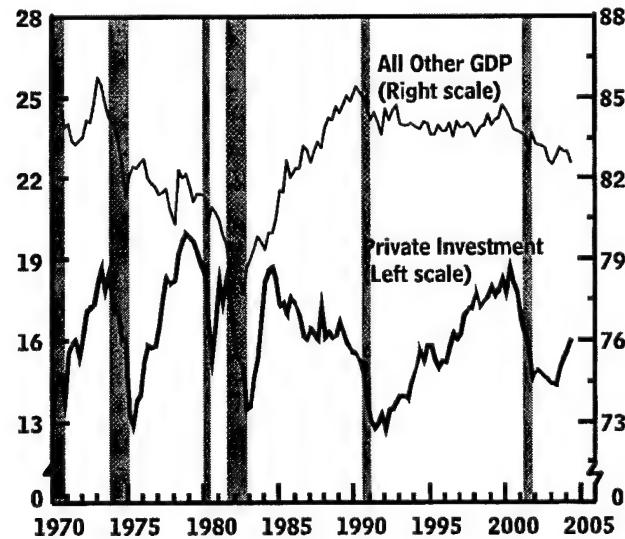
the same time, however, rising demand in the United States will increase imports, resulting in a slight reduction in real net exports in 2004 and only a modest gain in 2005. Consumption and investment by the federal government will expand at about the same rate as GDP; however, overall government spending (including expenditures by state and local governments) and residential construction will add little to the growth of demand. Notwithstanding those factors, demand growth in the private sector—led by business investment—is projected to continue the recovery and permit less stimulative fiscal and monetary policy.

**The Business Sector.** CBO forecasts that a recovery in investment by businesses will be a key force in the ongoing economic upturn. Even so, business investment will remain a smaller share of GDP than it has been in past expansions. Thus, the rapid growth that CBO expects in business fixed investment (purchases of equipment, software, and structures) and inventory investment is best thought of as regaining ground after investment's sharp drop during the recession rather than rising to an unusually high level.

**Figure 2-2.**

## Private Investment and the Business Cycle

(Percentage of potential GDP)

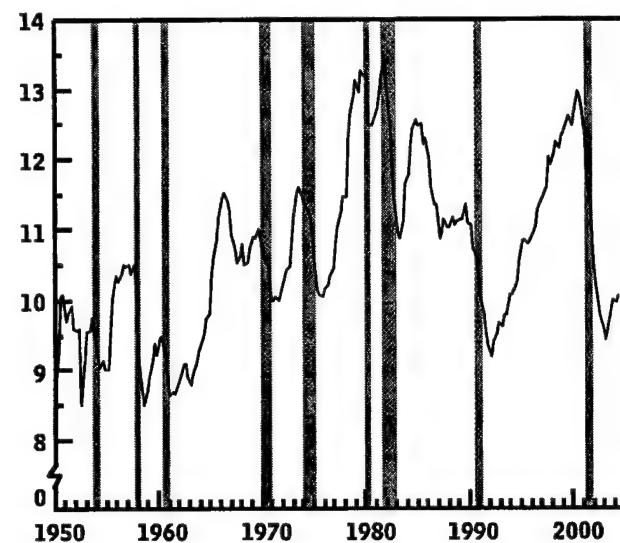


Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

**Figure 2-3.**

## Business Fixed Investment

(Percentage of potential GDP)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

**Business Fixed Investment.** Between the fourth quarter of 2000 and the first quarter of 2003, business fixed investment suffered an unusually steep and long-lasting decline, falling from 12.7 percent of potential GDP to just 9.4 percent (see Figure 2-3). Real business fixed investment fell at an average annual rate of 7.0 percent during that period after increasing by 5.7 percent annually, on average, during the previous 40 years. The most important factor in the decline was that demand for businesses' output grew more slowly than their ability to produce it with their existing capital and labor. Thus, in general, firms cut their payrolls and reduced investment below the levels needed to fully replace all of their depreciating equipment and structures. In addition, the cost of capital—the "hurdle" rate that the expected return from a new investment must exceed in order for that investment to be considered profitable—increased, as stock prices declined and investors demanded higher risk premiums on corporate securities.<sup>5</sup> Another reason for the drop in fixed investment was that the high rate of firms' spending during the late 1990s for certain types of information tech-

5. The risk premium is the additional return that investors require to hold assets whose returns are more variable than those of assets that are free of default risk—such as U.S. Treasury securities.

**Box 2-1.****How Much Slack Is Left in the Economy?**

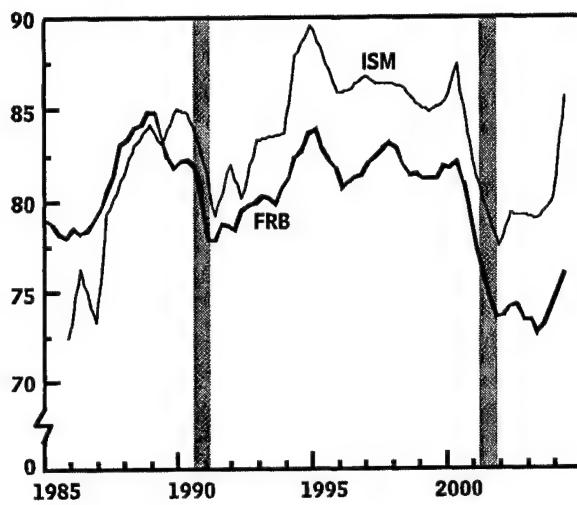
A key factor in determining how fast gross domestic product (GDP) can expand over the next two years is the amount of “slack”—underutilized capital and labor—that remains in the economy. With more underutilized resources, the economy faces fewer bottlenecks to growth, and the Federal Reserve can follow a more stimulative monetary policy. Thus, the more slack the economy has, the more rapid the growth of GDP is likely to be. The reverse is also true—with less slack, GDP is likely to grow more slowly. Available evidence from a variety of sources suggests a wide range of answers to the question of how much slack there now is. The Congressional Budget Office’s (CBO’s) estimate falls in the middle of that range.

Data from the labor market, for example, generally indicate that at least some underused economic capacity remains, but different measures offer different views of how much. By July 2004, the unemployment rate was not far from its projected long-run level, implying little additional room for gains in employment resulting purely from the typical ups and downs of the business cycle. At the same time, the ratio of employment (the number of people working) to the working-age population was still well below its values prior to the recession, suggesting that employment could rise significantly if that ratio returned to

its level before the downturn. CBO takes a middle view: it expects that the labor force participation rate (the share of the population ages 16 and older who are either employed or actively looking for work) will

**Measures of Capacity Utilization in Manufacturing**

(Percent)



Sources: Congressional Budget Office; Federal Reserve Board; Institute for Supply Management.

Note: The ISM collects data only for May and December. Data for other months were interpolated by CBO.

nology (particularly telecommunications equipment) apparently was unsustainable.

Those adverse conditions have improved, causing fixed investment to grow in recent quarters. Demand is now outpacing businesses’ ability to supply it with their present capital and workforce, as demonstrated by the rising level of employment over the past year. Between October 2002 and July 2004, stock prices climbed by 29 percent while risk premiums on corporate debt fell—both of which reduced the cost of capital. And investment in telecommunications equipment has begun to bounce back. As a result, real investment in equipment

and software grew at an average annual rate of 12 percent between the first quarter of 2003 and the second quarter of 2004. The prospect of further growth in spending for equipment is indicated by unfilled orders for nondefense capital goods excluding aircraft, which in June 2004 reached their highest level since September 2001. Nonresidential construction has lagged behind investment in equipment, but it appears to be rebounding as well, with positive real growth reported for the second quarter of 2004.

Changes in the tax code that were enacted in 2002 and 2003 are also contributing to the upturn in investment.

**Box 2-1.****Continued**

partially rebound and the unemployment rate will improve by less than half a percentage point.

The range reflected in estimates of the utilization rate of manufacturing capacity by the Federal Reserve Board and the Institute for Supply Management (ISM) is even broader than the range for the labor market. The Federal Reserve's more widely used measure of manufacturing capacity utilization has remained well below its historical average; in contrast, the ISM's measure jumped above its average during the first half of 2004 (see the figure). Although it is difficult to infer conditions in the overall economy from a measure that applies only to manufacturing, the Federal Reserve's estimate implies more room for growth in the economy than the ISM's estimate does.

Measures of slack in the labor market and in manufacturing each focus on a single component of the total amount of underutilized economic resources. In contrast, CBO uses a summary measure of underemployed capacity: the gap between its estimate of potential GDP and actual GDP. That so-called GDP gap was about 1.3 percent at the beginning of 2004, CBO estimates—an indication that a moderate amount of slack remained. (By comparison, the GDP gap reached 3.1 percent in early 2003.) CBO's projection of potential GDP and thus its estimate of

the GDP gap depend not only on trends in labor hours and the capital stock but also on its estimate of total factor productivity, or TFP (defined as the average real output per unit of combined labor and capital inputs). The higher the level of TFP, the more the amount of GDP that can be produced from a given level of labor and capital and thus the greater the slack remaining in the economy for a given level of actual GDP.

TFP has grown rapidly over the past four years, much faster than might be expected on the basis of historical patterns. As a result, potential TFP, and hence potential GDP and the GDP gap, are more uncertain than usual. Were TFP to revert to its historical trend through below-average growth in productivity, potential GDP would be lower than CBO estimated, and the remaining gap between actual and potential GDP would soon disappear. In that case, the likely outcomes would be slower growth or higher inflation than CBO expected, or a combination of both. By contrast, if TFP continued to grow at a typical or above-average rate from its currently high level, potential GDP would be greater than CBO estimated. Given that circumstance, real (inflation-adjusted) GDP would probably grow more rapidly than CBO anticipated, and inflationary pressures would be more muted.

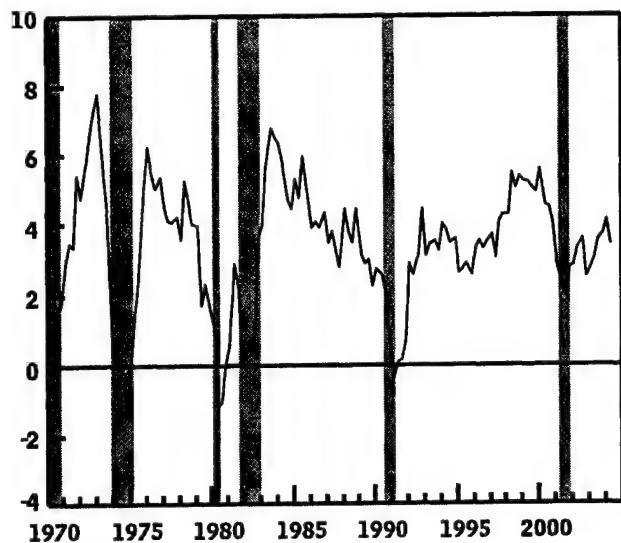
The Job Creation and Worker Assistance Act of 2002 (JCWAA) contained incentives to bolster businesses' spending on equipment and structures by temporarily increasing the fraction of new investment that firms can "expense" (deduct from their taxable income immediately rather than over time). JGTRRA expanded those incentives by allowing firms, through the end of 2004, to expense 50 percent of the value of new equipment and of some structures in the tax year in which the property is acquired. In addition, it increased, through 2005, the limit on small businesses' expensing of new depreciable assets. Those incentives will boost investment in equipment by at least 3 percent in 2004, CBO estimates, both

by reducing the cost of such investment and by inducing some firms to shift some investment from 2005 to 2004, to take advantage of the expensing provision before it expires.

In CBO's estimation, the growth of business fixed investment is likely to continue at a brisk clip. Many businesses need to expand their capacity to meet a greater demand for their products or to invest in new capacity to replace equipment and structures that are depreciating in value. Yet investment could be weaker than CBO expects if the growth of other components of demand was unexpect-

**Figure 2-4.****Real Personal Consumption Expenditures**

(Percentage change from previous year)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

edly lackluster or if businesses and investors lost confidence in the prospects for future profitability.

The strong growth of demand over the past year is likely to boost business fixed investment in the future since such spending responds only gradually to greater demand. The importance of past growth is especially significant for construction, where the lags between demand and investment are longer than for other types of capital. In the past, nonresidential construction excluding mining and farming has responded to upturns in employment during the prior four years. According to CBO's forecast, the rate of employment as measured in four-year intervals is beginning to rise and will climb even more rapidly in 2005. Also suggesting a boost in future construction are a drop in the vacancy rate for offices in the second quarter of 2004 and a rise in the level of billings and customer inquiries reported by members of the American Institute of Architects.

*Inventory Investment.* Businesses' spending on inventories, like their fixed investment, is benefiting from an end to the sluggishness in demand that was responsible for the slump in such spending in recent years. The strong growth in demand forecast for 2004 and 2005, combined

with firms' currently lean inventory stocks (even after accounting for the historical downward trend in the ratio of inventories to sales), is likely to trigger significant accumulation of inventories. Businesses restocked their shelves during the second quarter of 2004 at the highest rate seen since 2000, and CBO forecasts that the swing from drawing down inventories to rebuilding them will add significantly to the growth of GDP in 2004 and 2005.

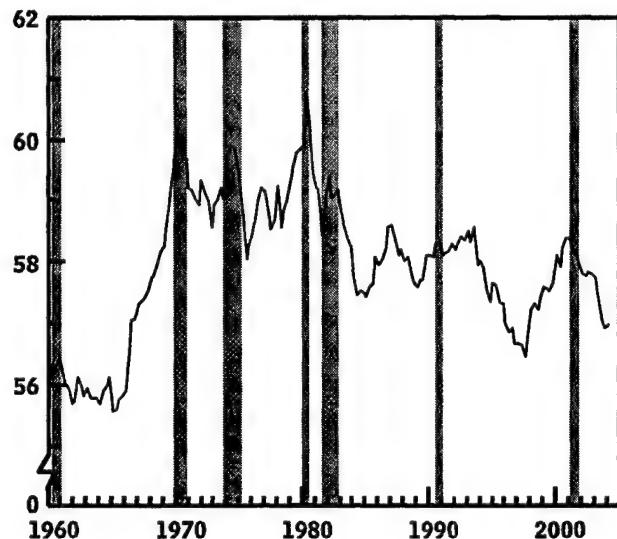
**The Household Sector.** Spending by the household sector will contribute to economic growth during 2004 and 2005 but will follow the overall economy rather than lead it. During the recent recession and the early part of the recovery, stimulative fiscal and monetary policies contributed to both consumer spending and residential investment, keeping the growth of those sectors positive (in contrast to the contractions they experienced in most previous recessions; see Figure 2-4). That relative strength during the cyclical downturn in 2001 also suggests less of a cyclical rebound in those sectors than in previous recoveries. Under current law, tax provisions will tighten somewhat in 2005; at the same time, CBO forecasts, interest rates will rise. As a result, consumer spending will grow more slowly than GDP over the remainder of 2004 and 2005, whereas real residential investment is likely to decline—although it will remain at a high level.

*Income.* Expansionary fiscal policy accounted for much of the growth in disposable (after-tax) income over the past three years, but during the next two years, the main engines of income expansion are expected to be the rise in real GDP and in labor's share of output. Between 2001 and 2003, tax cuts and expanded government transfer payments sharply boosted disposable income. EGTRRA and JGTRRA each reduced individual income taxes, and JCWAA and subsequent extensions provided additional unemployment benefits. Those measures helped disposable income grow at a solid pace despite the slow growth of personal income. Between the second quarter of 2001 and the third quarter of 2003, when most of the fiscal legislation took effect, disposable income grew at an average annual rate of 5.0 percent. By comparison, personal income excluding transfers grew at an average annual rate of 1.9 percent.

A moderate tightening of fiscal policy will remove some of that positive impact on disposable income in 2005. Provisions of JGTRRA will hold down income growth by temporarily reducing a few tax benefits—the child tax

**Figure 2-5.****Labor Compensation**

(Percentage of gross domestic income)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

credit, the expanded 15 percent bracket and standard deduction ("marriage penalty relief"), and the expanded 10 percent bracket—and by eliminating the increase in the exemption under the alternative minimum tax. Also dampening income in 2005 relative to 2004 is a likely reduction in tax refunds. Certain tax cuts enacted in 2003 in JGTRRA were retroactive to the beginning of that year, but the government's withholding of taxes for 2003 did not fully account for it. That led to bigger refunds and smaller final payments in 2004—outcomes that CBO does not expect will recur in 2005. Together, the changes under JGTRRA and the reduction in refunds are likely to reduce disposable income in fiscal year 2005 by 0.3 percent of personal income, or about \$34 billion.

Nonetheless, in CBO's estimation, two other factors will keep both personal income and disposable income growing at a healthy rate in 2004 and 2005. First, rapid GDP growth will contribute to growth in the income of the people who produce that output, and second, income from labor will grow more rapidly than GDP. Since the onset of the recession in 2001, the share of gross domestic income going to workers has fallen, at least partly because of the weak demand for labor (see Figure 2-5). That decline in labor's share helped hold down growth in pretax

income—which partially blunted the effect of lower tax rates on disposable income. CBO expects that stronger demand for labor will reverse some of that decline over the next few years.

**Households' Finances.** Households' finances have improved since the recession and are unlikely to impede consumption in 2004 and 2005, according to CBO's estimates. By the first quarter of 2004, delinquency rates at commercial banks on credit cards, other consumer loans, and residential real estate had each fallen well below the levels they reached during the 2001 recession. The ratio of households' financial obligations to disposable income had also fallen slightly below its recession peak. (Nevertheless, it remains high.) Thus, although households' finances are still vulnerable to a downturn in the economy, they are not likely to precipitate one.

**Consumption.** CBO expects that solid growth in households' income will enable real consumption to post sturdy gains during the remainder of 2004 and in 2005. Those gains will be somewhat larger than the rise in consumption during the past three years, as stronger GDP growth fuels a more rapid expansion of pretax income and falling oil prices (in 2005) add to real income growth. Nonetheless, consumption will not grow as fast as overall GDP, CBO forecasts, because of the effect on disposable income of tighter fiscal policy in 2005.

On the one hand, a number of factors could lead to slower growth of real consumption than CBO anticipates—for example, a slower pace of income growth, a decline in households' wealth owing to lower prices for houses or corporate equities, a sharp worsening of consumers' finances, or a steep upsurge in oil prices resulting from disruptions in supply. On the other hand, consumption could be stronger than CBO forecasts if those factors became more favorable than expected.

**Housing.** With construction and sales of homes already at record highs and mortgage rates likely to rise further, residential investment during the remainder of 2004 and in 2005 is expected to curb the growth of demand. The lowest mortgage rates in more than 30 years led to home sales in 2003 that surpassed all other years', giving a big boost to construction. Although mortgage rates have since risen, the low level of rates relative to those in the past, the anticipation of further rate increases, and the growth of employment have kept home buying strong. CBO foresees further hikes in mortgage rates and, as they oc-

cur, a slowdown in housing activity from its current level. That slowdown could be worse than anticipated if purchasers of homes today have unrealistic expectations about how much their homes will appreciate and potential buyers revise those expectations downward.

**Exports and Imports.** Overall, the international sector will slightly lessen the growth of GDP in 2004 and slightly add to it in 2005, CBO estimates. In 2004, the fast pace of U.S. economic growth will raise imports more than solid economic growth abroad will increase exports. Yet a gradual slowing of the rate at which foreigners want to add to their holdings of U.S. assets will result in a decline in the dollar, CBO forecasts, and in 2005, the United States' enhanced competitiveness—a result of that weaker dollar—will tip the balance toward greater growth of exports than of imports.

Changes in CBO's outlook for the foreign sector could substantially influence the accuracy of its entire forecast because events and conditions in that sector directly affect exports and imports and indirectly affect other parts of the economy. A further unexpected rise in world oil prices would reduce real consumer spending, whereas a sharp fall in oil prices would bolster it. Unexpectedly weak growth abroad could lead to a lower level of exports than CBO forecasts, whereas unexpectedly strong growth could lead to a higher level. A sudden lessening of foreigners' willingness to add to their holdings of U.S. assets would reduce the value of the dollar, ultimately aiding the trade balance. But it would also reduce the flow of foreign funds to interest-sensitive sectors, such as housing and business fixed investment, because interest rates would rise.

**Foreign Economic Conditions.** Economic growth in the industrialized countries is recovering from its slow pace in 2003. The *Blue Chip* consensus of roughly 50 private-sector forecasts expects that rising exports to a strengthening global economy will boost real GDP growth in countries that use the euro—rates will climb from 0.4 percent in 2003 to 1.8 percent in 2004 and 2.2 percent in 2005, in the estimation of the consensus. Growth in the United Kingdom is likely to be stronger than that, aided by more robust domestic demand than in the euro area. Japan's recovery, which has been jump-started by exports to China, is strengthening and broadening, and the Canadian economy, stimulated by vigorous U.S. growth and improved economic conditions worldwide, is bouncing back after

posting a mediocre rise in output in 2003. In Australia, a pickup in growth is expected as well.

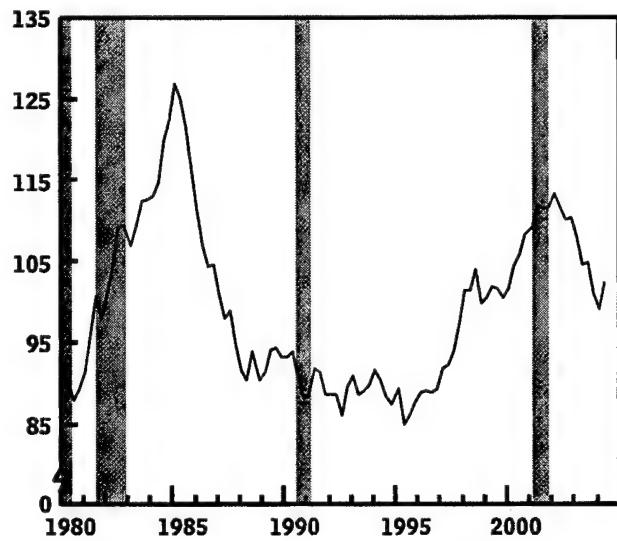
Also expanding, on average, are the economies of the United States' trading partners in the developing world. Economic conditions in Latin American countries are responding to higher prices for commodities, more-competitive currencies, and improved investor confidence. The *Blue Chip* consensus expects real GDP in Mexico and Brazil to grow by more than 3 percent annually in 2004 and 2005 after little or no growth in 2003. Although economic growth in China is not expected to accelerate in 2004, any slowdown there is still likely to leave output expanding at a robust rate. Meanwhile, other developing countries in Asia will continue to benefit from growth in China, Japan, and the United States. For the two-year forecast period, the *Blue Chip* consensus anticipates stronger growth than in 2003 in South Korea, Taiwan, Singapore, and Hong Kong.

**The Dollar's Exchange Rate.** CBO expects the value of the dollar generally to move downward during the rest of 2004 and in 2005—because the United States' trade deficits remain large and because a growing level of net foreign indebtedness is likely to make overseas investors less willing to increase their U.S. holdings. The dollar had already lost about 13 percent of its value against a broad basket of currencies between its peak in early 2002 and January 2004 (see Figure 2-6). For the most part, the dollar dropped relative to the currencies of industrialized countries; it remained steady against the currencies of many developing countries because those nations intervened decisively in the currency markets to stabilize their exchange rates relative to the dollar. The U.S. currency regained some of its lost value, rebounding by about 5 percent through May of this year, but it fell in June and July. In CBO's estimation, that overall downward trend is likely to continue.

**Imports, Exports, and the Trade Balance.** The U.S. trade deficit has widened since the end of the recession in 2001, partly because the United States' economy has recovered more rapidly than the economies of most of its trading partners and partly because of delayed effects from the rise in the dollar's value during 2000 and 2001. Between the fourth quarter of 2001 and the second quarter of 2004, real imports grew at an average annual rate of 7.8 percent, whereas real exports grew more slowly, at an average annual rate of 5.8 percent. Consequently, net im-

**Figure 2-6.****Real Trade-Weighted Value of the U.S. Dollar**

(Index, March 1973 = 100)



Sources: Congressional Budget Office; Federal Reserve Board.

Note: The real trade-weighted value of the U.S. dollar is a weighted average of the foreign exchange values of the dollar against the currencies of a large group of major U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.

ports rose from \$352 billion (calculated as an annual rate) at the end of 2001 to \$561 billion in early 2004.

In CBO's forecast, the trade balance gradually improves during the second half of 2004 and in 2005. Real imports and exports will both rise, in CBO's estimation, borne upward by strong growth in both the United States and the rest of the world. A lower dollar will aid the trade balance by further adding to growth in exports and by curbing growth in imports. Yet although the downward movement expected in the dollar is likely eventually to contribute to a substantial improvement in the trade balance, the improvement during the second half of 2004 and in 2005 will be modest, CBO forecasts.

**The Government Sector.** Under current law, the rate of growth of real federal purchases of goods and services will exceed that of GDP in 2004 and 2005, in CBO's estimation. From 2001 to 2003, real federal consumption and investment grew at an average annual rate of 6.8 percent.

That growth will slow to less than 5 percent in 2004, CBO forecasts, but then accelerate slightly in 2005 as a result of higher defense spending. CBO's estimate reflects appropriations already enacted for the Department of Defense and for certain other programs funded in the defense appropriation act.

The growth of real consumption and investment by state and local governments is forecast to accelerate during 2004 and 2005 from its unusually slow rate in 2003. Nevertheless, it will lag behind the rate of growth of overall GDP, in CBO's estimation. Continuous budgetary pressures since the 2001 recession have forced state and local governments to slow the rise in real consumption and investment to an average annual rate of just 0.6 percent during 2003 and the first half of 2004. Those budgets have improved in response to that restraint and because of increased revenues, but their continued weakness will constrain state and local government spending in the near future. CBO thus anticipates slow growth in real state and local purchases during the second half of 2004 and in 2005.

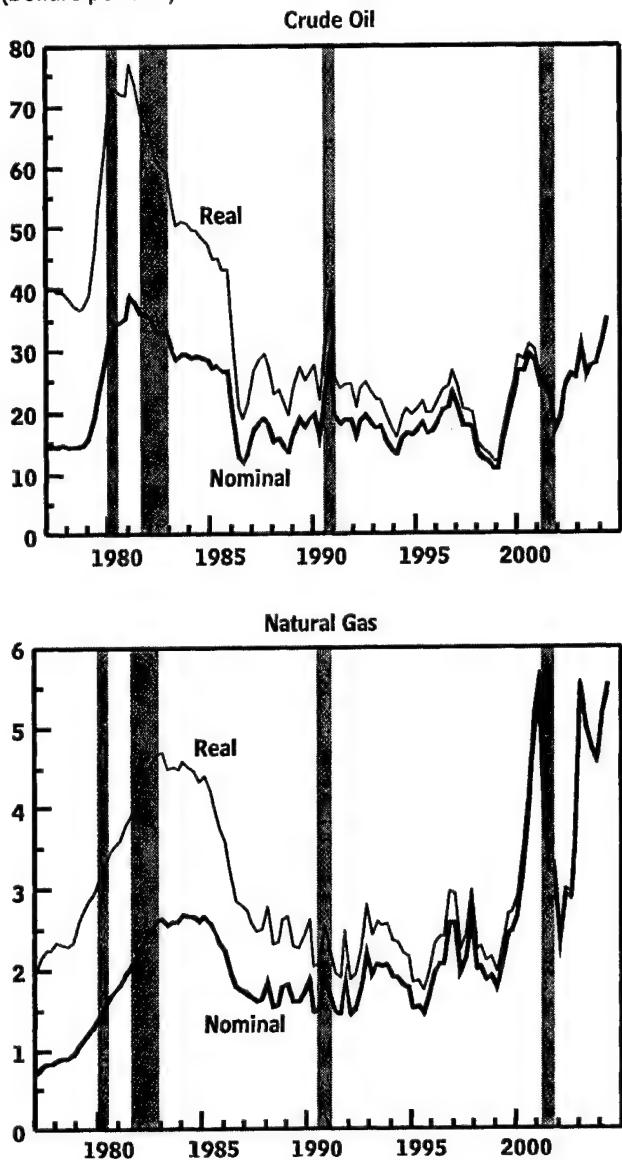
**Inflation**

The rate of growth of the consumer price index (CPI) accelerated noticeably during the first half of 2004, partly because of a sharp hike in energy prices. The rising global demand for oil, notably by China, and fears that supplies from the Middle East, Russia, and Venezuela would be disrupted caused the price of crude oil to jump by more than \$5 per barrel (or almost 20 percent) during the first half of 2004 (see Figure 2-7). The price of gasoline climbed both because of that boost in crude oil prices and because refining and distribution costs per gallon increased. (Although the price of crude oil hit record levels in early August, it remains well below the level of the early 1980s after adjusting for inflation.) In response to rising demand, the price of natural gas in the United States is estimated to have jumped by almost \$1 per thousand cubic feet (or about 20 percent) during the first half of 2004 after declining for most of 2003. Thus, the CPI for energy rose at an annual rate of 26 percent during the first half of 2004 after increasing during 2003 at the above-average rate of 7 percent (measured fourth quarter over fourth quarter).

Core inflation (excluding food and energy) also accelerated during the first half of 2004 but less quickly than

**Figure 2-7.**  
**Energy Prices**

(Dollars per unit)



Sources: Congressional Budget Office; Department of Energy, Energy Information Administration.

Notes: Crude oil prices are the refiners' acquisition prices in dollars per barrel. The natural gas price is the wellhead price in dollars per thousand cubic feet.

The price of natural gas for the second quarter of 2004 is a forecast taken from Energy Information Administration, *Short-Term Energy Outlook* (August 2004), Table 4. Real prices, which are expressed in 2003 dollars, were computed using the research series of the consumer price index.

overall inflation. Core consumer prices rose at an annual rate of 2.4 percent during the first half of 2004 after climbing by 1.2 percent in 2003 (measured fourth quarter over fourth quarter). Much of the acceleration in core inflation stemmed from increased growth in the index for shelter, which accounts for about 40 percent of the core CPI-U (the consumer price index for all urban consumers excluding food and energy) and includes apartment rents, imputed rents for owner-occupied homes, and the cost of lodging away from home. The index for shelter grew unusually slowly during 2003 and then rebounded early in 2004—for reasons that are not well understood (see Figure 2-8). CBO assumes that much of the recent acceleration in those prices does not reflect an increase in the underlying trend but is instead temporary and the result, perhaps, of measurement problems. Therefore, some of the rapid growth in core inflation should be considered temporary as well.

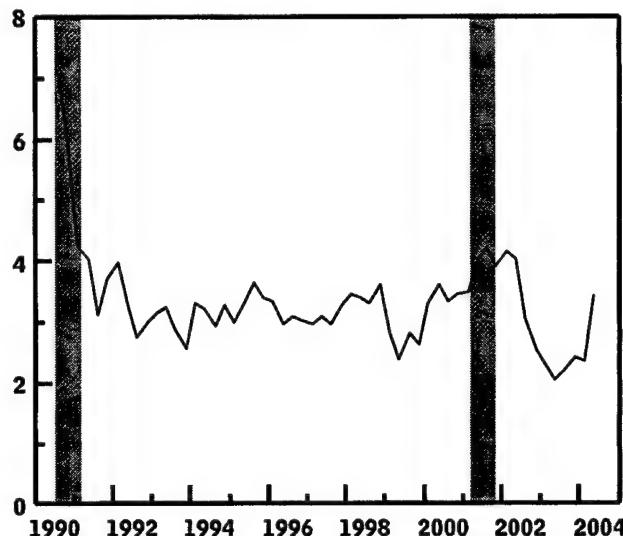
CBO's forecast assumes that during the second half of 2004 and in 2005, prices will grow more slowly than they did in the first half of this year, as both energy prices and shelter price inflation fall. (When the forecast was completed in July, CBO expected that oil would cost significantly less in mid-2005 than it did in mid-2004).<sup>6</sup> CBO projects that the CPI-U will grow by 3.0 percent (measured fourth quarter over fourth quarter) during the whole of 2004, a pace well below the annual rate of 4.0 percent reported for the first half of the year. In 2005, the consumer price index will rise by just 1.8 percent, CBO forecasts.

Moderate growth in unit labor costs (the costs required to produce a unit of output) will help hold inflation in check, in CBO's estimation. Such costs have fallen slightly over the past three years—the longest period with no increase since the early 1960s—which helped keep inflation low during that time. The quiescence of unit labor costs in recent years stems from moderate growth of labor compensation coupled with unusually rapid growth of productivity. Although the cost of benefits—notably, employers' contributions to defined-benefit pension plans and group health insurance—has grown rapidly since the 2001 recession (as measured by the employment cost in-

6. Since the forecast was completed, however, oil prices have continued to rise as a result of strong world demand and a variety of supply-side problems.

**Figure 2-8.****The Consumer Price Index for Shelter**

(Percentage change from previous year)



Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

dex for civilian workers), wage growth has slowed, preventing the rate of growth of overall labor compensation from accelerating (see Figure 2-9). Unit labor costs are unlikely to continue shrinking; nevertheless, CBO estimates that productivity will increase at a fast enough pace to keep what it expects will be moderate growth in compensation from boosting inflation.

Inflation could, of course, turn out to be much different than CBO has foreseen, with energy prices posing the main risk of a substantially different outcome. A terrorist attack or other major disruption to the supply of oil could push energy prices sharply higher and, in turn, boost inflation (as measured by the CPI-U). Alternatively, energy prices could fall more rapidly than expected if the Chinese economy slowed at the same time that members of OPEC (the Organization of Petroleum Exporting Countries) and other oil exporters were boosting supply. Another factor with an uncertain outcome is the very accommodative monetary policy of recent years—some analysts worry that it might push up inflation. A further uncertainty in the inflation outlook is the recent acceleration in the shelter index. If much of that rise is not temporary, as CBO assumed, overall inflation might grow more rapidly than expected. For example, prices that continued to increase at the high rates of early 2004 would

almost certainly lead to core CPI-U inflation that was greater than CBO anticipated.

**Monetary Policy**

Now that the economy is expanding at a solid pace and labor market conditions are showing gradual improvement, CBO expects that the Federal Reserve will move away from the considerably accommodative monetary policy it has pursued over the past year and increase the federal funds rate, its main policy instrument. (The federal funds rate is the interest rate that financial institutions charge each other for overnight loans of their monetary reserves.) At the end of June, the Federal Reserve raised the funds rate—from 1 percent to 1.25 percent—for the first time since May 2000; it raised the rate further, to 1.5 percent, in early August. Additional increases are expected that will return monetary policy to a relatively neutral stance—that is, evenly balanced between supporting the pace of expansion and maintaining low inflation, according to the central bank. In statements accompanying its policy announcements, the Federal Reserve has indicated that the pace of increases in the federal funds rate is expected to be “measured” but that it could quicken “as needed” to maintain low inflation. The consensus among participants in the financial markets when CBO’s forecast was completed was that the federal funds rate would climb to 2.25 percent by early 2005 and then move toward 3 percent and above after mid-2005.

CBO’s outlook for the rate on three-month Treasury bills is consistent with the markets’ consensus view of monetary policy and the federal funds rate: CBO’s forecast rises over the next two years as the forecast for the federal funds rate rises. In CBO’s estimation, the three-month rate will increase from an average of 1.0 percent in 2003 to 1.3 percent in 2004 and 2.6 percent in 2005 (see Figure 2-10).

Long-term rates have already risen in anticipation of the Federal Reserve’s policy tightening and are thus expected to increase by less than short-term rates will. As prospects for economic growth improved over the past year, the yield on 10-year Treasury notes rose from an average of 3.6 percent during the second quarter of 2003 to an average of 4.6 percent during the second quarter of 2004. CBO estimates that the yield on 10-year Treasury notes will average 4.6 percent during 2004 and 5.4 percent during 2005.

### A Comparison of Two-Year Forecasts

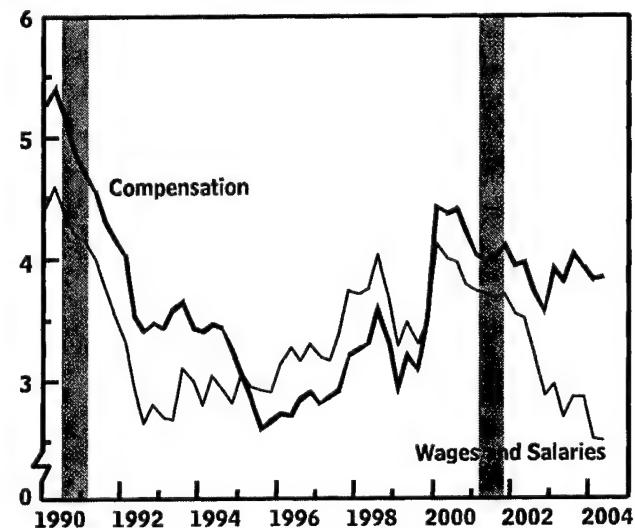
CBO's assessment of the economy's near-term outlook is moderately more optimistic than those of the Administration and the *Blue Chip* consensus (see Table 2-3). CBO expects that the rate of growth of real GDP in 2004 will be 0.2 percentage points slower than the pace that the Administration anticipates; however, it expects somewhat stronger growth in 2005 than the Administration does. At the same time, CBO's forecast for slightly faster growth of the GDP price index in 2004 and slightly slower growth in 2005 means that it expects nominal GDP in both years to rise somewhat more quickly than the Administration does. CBO's two-year forecast for the unemployment rate and the rate on three-month Treasury bills is almost the same as the Administration's, but CBO anticipates somewhat higher yields on 10-year Treasury notes for 2005. A further point of difference is that CBO's outlook foresees slightly slower consumer price inflation in 2005 relative to the Administration's.

Compared with the *Blue Chip* consensus forecast, CBO's two-year outlook is somewhat more optimistic, with more rapid growth in 2004 and 2005 of both real and nominal GDP. *Blue Chip*'s and CBO's inflation forecasts are similar for 2004, but for 2005, CBO foresees lower

**Figure 2-9.**

### The Employment Cost Index

(Percentage change from previous year)



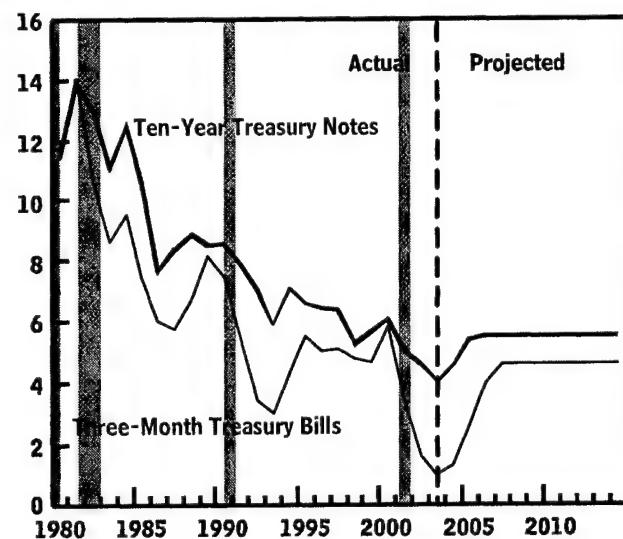
Sources: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Note: Compensation includes wages and salaries and benefit costs.

**Figure 2-10.**

### Interest Rates

(Percent)



Sources: Congressional Budget Office; Federal Reserve Board.

Note: All data are annual values.

rates of increase than *Blue Chip* does for both the CPI-U and the GDP price index. CBO and the consensus anticipate similar outcomes for the unemployment rate and for long-term interest rates in 2004 and 2005 and for short-term rates in 2004. However, CBO's forecast for short-term rates in 2005 is lower than that of the consensus.

In its midyear report to the Congress, the Federal Reserve presented its economic outlook in the form of ranges known as central tendencies, which are based on forecasts by the members of its board of governors and the presidents of the Federal Reserve banks.<sup>7</sup> CBO's outlook for the growth of real GDP (measured fourth quarter over fourth quarter) is slightly below the Federal Reserve's central tendency for 2004 but falls within the tendency for 2005. Similarly, CBO expects the unemployment rate at the end of 2004 to be slightly higher than the Federal Reserve's central tendency but to be within it at the end of 2005. However, CBO's forecast for growth of the price index for personal consumption expenditures, excluding food and energy, falls within the central tendency for both 2004 and 2005.

7. See Federal Reserve Board of Governors, *Monetary Policy Report to the Congress* (July 20, 2004).

**Table 2-3.****Comparison of CBO's, *Blue Chip's*, and the Administration's Forecasts for Calendar Years 2004 and 2005**

	Actual 2003	Forecast 2004	Forecast 2005
Nominal GDP (Percentage change)			
Blue Chip consensus	4.9	6.7	5.9
CBO	4.9	6.8	6.1
Administration	4.8	6.7	5.7
Real GDP (Percentage change)			
Blue Chip consensus	3.0	4.4	3.7
CBO	3.0	4.5	4.1
Administration	3.1	4.7	3.7
GDP Price Index (Percentage change)			
Blue Chip consensus	1.8	2.2	2.1
CBO	1.8	2.2	1.8
Administration	1.7	1.9	1.9
Consumer Price Index <sup>a</sup> (Percentage change)			
Blue Chip consensus	2.3	2.7	2.4
CBO	2.3	2.6	2.0
Administration	2.3	2.5	2.3
Unemployment Rate (Percent)			
Blue Chip consensus	6.0	5.5	5.3
CBO	6.0	5.6	5.2
Administration	6.0	5.5	5.3
Three-Month Treasury Bill Rate (Percent)			
Blue Chip consensus	1.0	1.4	2.9
CBO	1.0	1.3	2.6
Administration	1.0	1.3	2.6
Ten-Year Treasury Note Rate (Percent)			
Blue Chip consensus	4.0	4.6	5.3
CBO	4.0	4.6	5.4
Administration	4.0	4.5	5.1

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board; Aspen Publishers, Inc., *Blue Chip Economic Indicators* (August 10, 2004); Office of Management and Budget, *Mid-Session Review: Fiscal Year 2005* (July 30, 2004).

Note: The Administration's forecast is based on data taken from the national income and product accounts before the annual revisions on July 30, 2004.

a. The consumer price index for all urban consumers.

**The Outlook Beyond 2005**

Over the medium term—from 2006 to 2014—real GDP will grow at an average annual rate of 2.8 percent, CBO expects, the same rate as that of potential real GDP during the same period. Inflation, as measured by the CPI-U, will average 2.2 percent during the period, in CBO's estimation, and the rate of unemployment, 5.2 percent. Over the medium term, the rate on three-month Treasury bills will rise to an average of 4.5 percent, and the rate on 10-year Treasury notes will average 5.5 percent.

To develop its medium-term projections, CBO extends historical patterns in the factors that underlie its estimate of the growth of potential GDP, such as the expansion of the labor force, productivity, and the rate of national saving. In doing so, CBO takes into account the possibility of business-cycle fluctuations by basing projected trends on historical averages and growth rates that include periods of expansion and recession. CBO's medium-term projections also reflect the effects on potential output of changes in fiscal policy.

**Potential Output**

Potential output during the 2004-2014 period will grow at an average annual rate of 2.8 percent, CBO projects—about the same pace as it anticipated in January 2004 (see Table 2-4). That estimate results from roughly offsetting changes in several variables that underlie the projection for potential output, including the potential labor force, the capital stock, and total factor productivity (TFP).<sup>8</sup>

Over the 2004-2014 period, the average annual growth of the potential labor force is projected to be 0.9 percent—about a tenth of a percentage point faster than CBO estimated last January.<sup>9</sup> To reflect information from the 2000 census, CBO updated its estimates of the U.S. population and used revised historical data on the labor force and employment. Those data suggest a faster trend in labor force growth than CBO assumed in preparing its January estimates.

The growth of capital services—the flow of productive services from existing capital—will average 3.7 percent annually during the period, CBO estimates, or about

8. Total factor productivity is the average real output per unit of combined labor and capital inputs.
9. For more details, see CBO's updated labor force projections, available at [www.cbo.gov](http://www.cbo.gov).

**Table 2-4.****Key Assumptions in CBO's Projection of Potential Output**

(By calendar year, in percent)

	Average Annual Growth						Projected Average Annual Growth		
	1950-1973	1974-1981	1982-1990	1991-1995	1996-2003	Total, 1950-2003	2004-2009	2010-2014	Total, 2004-2014
<b>Overall Economy</b>									
Potential Output	3.9	3.3	3.1	2.6	3.4	3.5	3.1	2.6	2.8
Potential Labor Force	1.6	2.5	1.6	1.2	1.2	1.6	1.1	0.6	0.9
Potential Labor Force Productivity <sup>a</sup>	2.3	0.8	1.4	1.4	2.2	1.8	2.0	1.9	1.9
<b>Nonfarm Business Sector</b>									
Potential Output	4.0	3.6	3.2	3.0	3.9	3.7	3.4	2.9	3.2
Potential hours worked	1.4	2.3	1.4	1.4	1.4	1.5	1.2	0.7	1.0
Capital input	3.9	4.5	4.1	2.5	4.6	4.0	3.9	3.5	3.7
Potential total factor productivity	1.9	0.7	0.9	1.2	1.6	1.4	1.4	1.3	1.4
Potential TFP excluding adjustments	1.9	0.6	1.0	1.2	1.2	1.4	1.2	1.2	1.2
TFP adjustments	0	0	0	*	0.4	0.1	0.2	0.1	0.2
Computer quality <sup>b</sup>	0	0	0	*	0.1	*	*	*	*
Price measurement <sup>c</sup>	0	0	0	*	0.1	*	0.1	0.1	0.1
Temporarily faster growth <sup>d</sup>	0	0	0	0	0.2	*	*	0	*
Contributions to Growth of Potential Output (Percentage points)									
Potential hours worked	1.0	1.6	1.0	1.0	1.0	1.1	0.8	0.5	0.7
Capital input	1.2	1.3	1.2	0.8	1.4	1.2	1.2	1.0	1.1
Potential TFP	1.9	0.7	0.9	1.2	1.6	1.4	1.4	1.3	1.4
Total Contributions	4.0	3.7	3.1	3.0	3.9	3.7	3.4	2.9	3.2
<b>Memorandum:</b>									
Potential Labor Productivity <sup>e</sup>	2.6	1.2	1.7	1.6	2.5	2.2	2.2	2.2	2.2

Source: Congressional Budget Office.

Note: \* = between zero and 0.05.

- a. The ratio of potential output to the potential labor force.
- b. An adjustment for technological advances in the computer manufacturing sector.
- c. An adjustment for a conceptual change in the official measure of the GDP price index.
- d. An adjustment for the unusually rapid growth between 2001 and 2003.
- e. The estimated trend in the ratio of output to hours worked in the nonfarm business sector.

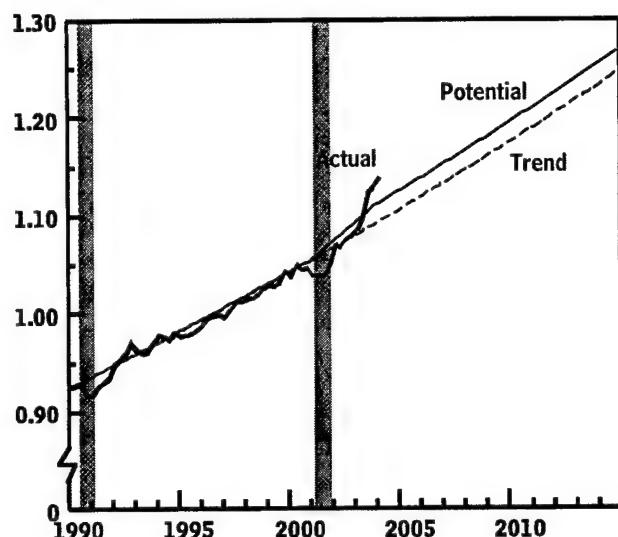
0.3 percentage points off the pace projected in January. Two factors explain that slower growth. First, the rate of investment spending by businesses is lower in the current projection, relative to the existing capital stock, than it was in CBO's earlier projection. Second, compared with the January estimate, the mix of investment assumed for the current projection is less heavily weighted toward

shorter-lived assets (which provide relatively high levels of capital services per dollar of investment).

Potential total factor productivity in CBO's medium-term projection grows at an average annual rate of 1.4 percent, or nearly 0.1 percentage point faster than in last winter's outlook. That revision results from CBO's re-

**Figure 2-11.****Total Factor Productivity**

(Index, 1996 = 1.0)



Source: Congressional Budget Office.

Note: Total factor productivity is the average real output per unit of combined labor and capital inputs.

evaluation of the trend in TFP growth in light of newly revised data from the NIPAs on output and capital stocks and a reassessment of the current amount of slack in the economy. Although CBO's current estimate of trend growth in TFP is higher than its January estimate, there is still a wide gap between actual TFP and its estimated trend at the end of 2003. To partially close that gap, CBO temporarily boosted its estimate of the growth of historical potential TFP—specifically, by an average annual rate of 0.6 percentage points during the 2001-2003 period (see Figure 2-11). That change raised the level of potential TFP at the end of 2003 and in all subsequent years by 1.8 percent.

**Unemployment**

CBO projects that the unemployment rate will reflect the gap between GDP and potential GDP over the medium term. Thus, with GDP expected to equal potential GDP, on average, the unemployment rate will average 5.2 percent for the entire 2006-2014 period, in CBO's estimation.

**Inflation**

Over the 2006-2014 period, average annual inflation is expected to match CBO's estimate of core inflation at the end of 2005. Prices will grow, CBO projects, at an average annual rate of about 2.2 percent as measured by the CPI-U and 1.7 percent as measured by the GDP price index. That outlook reflects CBO's view that the Federal Reserve will be able to maintain the rate of CPI-U inflation at between 2.0 percent and 2.5 percent, on average.

The difference that frequently exists between the growth of the CPI-U and that of the GDP price measure affects projections of some portions of the federal budget. Many spending programs and most income tax brackets are indexed to the CPI-U or the CPI-W (the index of consumer prices for urban wage earners and clerical workers). In contrast, the growth of taxable income is more closely related to growth in the GDP price index. Thus, the more that growth in the CPI-U can be expected to exceed growth in the GDP price index, the worse the budget outlook will be. CBO estimates that the wedge between the projected rates of growth of the CPI-U and the GDP price index will average somewhat less than 0.5 percentage points from 2006 to 2014—roughly equaling the average wedge between the two rates during the 1985-2003 period.<sup>10</sup>

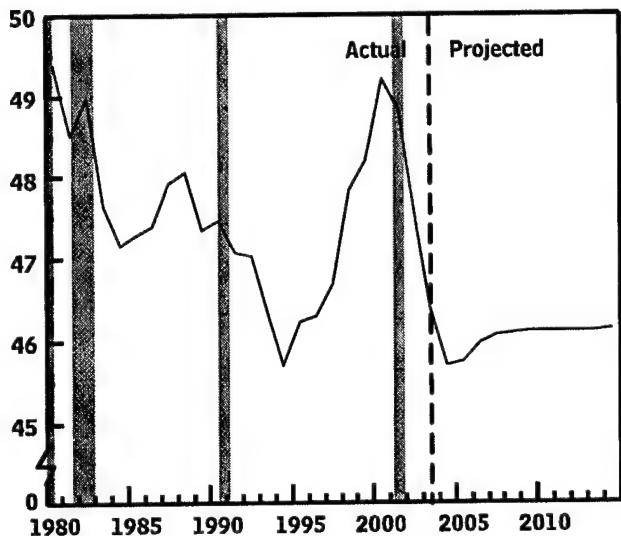
**Interest Rates**

CBO's projections of interest rates in the medium term, during which the economy is assumed to grow at trend rates, reflect its estimates of CPI-U inflation and real interest rates, which are based on analyses of historical rate averages and trends in the real return to capital. In CBO's estimation, real rates on three-month Treasury bills and 10-year Treasury notes during the 2006-2014 period will average 2.4 percent and 3.3 percent, respectively. The (nominal) rate on three-month bills will average 4.5 percent, CBO expects, and the rate on 10-year notes will average 5.5 percent.

10. The historical average of the wedge is calculated by using the CPI-U research series, which unlike the official CPI incorporates into the entire series most of the methodological improvements made by the Bureau of Labor Statistics since 1978.

**Figure 2-12.**  
**Wages and Salaries**

(Percentage of GDP)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

### Taxable Income

CBO's baseline projections of revenues are closely connected to its projections of national income. Because different categories of income are taxed at different rates, and some are not taxed at all, the projected distribution of income among its various components is a central factor in CBO's budget projections. For example, the average effective tax rate on wages and salaries is currently about 30 percent; the average effective rate on personal monetary interest income is under 10 percent. Shifts of income from interest to wages and salaries thus increase revenues.

CBO expects that the sharp drop over the past three years in the share of total income going to employees will be partially reversed over the next 10 years. However, CBO also believes that much of the projected rise in that income share will be attributable to an increase in benefits rather than to higher wages and salaries. (Those increased benefits will stem primarily from the continued rapid growth of employers' contributions to health insurance premiums and defined-benefit pension plans.) Consequently, the share of GDP accounted for by wages and salaries will remain near historically low levels, dropping

from 46.4 percent in 2003 to 45.7 percent in 2004, before rising to 45.8 percent in 2005 and an average of 46.1 percent during the 2006-2014 period (see Figure 2-12). Those figures are all well below the average annual share of 47.3 percent of the past 20 years because the share of GDP claimed by benefits will be larger in the future than it was in the past.

Although the NIPAs include various measures of corporate profits, CBO focuses on two of them in preparing its forecast. Book (before-tax) profits is the measure most closely related to the profits on which corporations pay tax and is thus affected by changes in the tax code. The law allows corporations to value inventories and depreciate assets at certain rates, and the book measure of profits is designed to reflect those statutory provisions. By contrast, the economic profits measure is not affected by the tax treatment of inventories and depreciation. Rather, it is designed to reflect the valuation of inventories and the rates of depreciation that more truly represent the worth of goods that businesses have on hand and the current economic usefulness of the capital stock. Except during periods of high inflation, economic profits have generally been larger than book profits.

Book profits and economic profits will differ sharply over the next decade because of statutory provisions that affect how companies can depreciate their assets for tax purposes. The partial-expensing provisions of JCWAA and JGTRRA that expire at the end of 2004 allow firms to depreciate some of their capital stock much more rapidly than the rate at which the economic usefulness of that capital is assumed to deteriorate. Those provisions will lower book profits by about \$180 billion in 2004, CBO estimates, because companies can take extra depreciation this year. Conversely, from 2005 on, the provisions are expected to increase book profits by about \$100 billion in 2005 and by declining amounts in subsequent years—because the extra depreciation taken from 2002 to 2004 means that less depreciation will be taken in later years.

The robust expansion of GDP, coupled with minimal growth in net interest payments (because of the low amount of corporate borrowing) will push economic profits up from a 9.3 percent share of GDP in 2003 to a 10.8 percent share in 2005, CBO forecasts. After 2005, both higher interest rates and the expanding portion of total GDP claimed by labor compensation will shrink economic profits as a share of GDP. CBO expects that share to average 9.5 percent from 2006 to 2014—which

is still well above the average annual rate of 8.4 percent for the 20-year period from 1984 to 2003. The average will remain high in part because lower interest rates are likely to hold businesses' interest expenses to a smaller share of GDP than they claimed during that past period.

## Changes in the Economic Outlook Since January 2004

The changes that CBO has made in its two-year forecast since January 2004 are relatively small (see Table 2-5). It revised downward the expected growth of real GDP for 2004 by 0.3 percentage points; in addition, growth in 2003 was 0.2 percentage points weaker than it had expected. CBO also reduced its forecast for the unemployment rate, by 0.2 percentage points for 2004 and 0.1 percentage point for 2005, after the rate fell more rapidly than expected in early 2004. The forecast for the interest rate on three-month Treasury bills for 2004 is the same as it was in January; for 2005, it is lower. CBO's estimate of the yield on 10-year Treasury notes for the next two years is unchanged.

The most noticeable revision to CBO's current forecast relative to January's is higher expected inflation. Prices for both energy and nonenergy goods and services rose more rapidly during the first half of 2004 than CBO had anticipated. As a result, its forecasts for consumer price inflation during 2004 and 2005 have been boosted by 1.0 and 0.3 percentage points, respectively. Since January 2004, CBO has revised its forecast for growth in the GDP price index by similar upward amounts.

Changes since January in the outlook beyond 2005 are small. Today, CBO expects a slightly faster pace of labor force growth over the medium term than it foresaw in January; accordingly, 0.1 percentage point has been added to its projection of the average annual rate of growth of real GDP. The current outlook for consumer price inflation is about the same as January's, but CBO now projects somewhat slower growth in the GDP price index and thus a slightly larger wedge between its growth rate and that of the CPI-U. Nevertheless, throughout the 2006-2014 interval, the levels of both indexes are projected to remain above the levels that CBO expected last January because they are now forecast to be much higher in 2005.

Compared with its estimates in January, CBO has raised its expectations about wages and salaries and profits, primarily because it now anticipates faster growth in nominal GDP than it did in January. Relative to GDP, wages and salaries grew surprisingly slowly during the first half of 2004, and CBO now projects that they will make up a smaller-than-expected share of output over the 2004-2014 period. In nominal terms, however, the level of wages and salaries will be higher, an estimate based on CBO's expectation of a higher level of nominal GDP, which stems partly from higher projected price inflation and partly from higher estimated growth of real GDP. In the case of profits, several factors led CBO to raise its forecast of their level for 2004 and 2005, including higher projected nominal GDP, a smaller-than-expected GDP share of wages and salaries in early 2004, higher-than-expected economic profits during late 2003 and early 2004, and lower short-term interest rates projected for 2005.

**Table 2-5.****CBO's Current and Previous Economic Projections for Calendar Years 2004 Through 2014**

	Actual 2003	Forecast		Projected Annual Average	
		2004	2005	2006-2009	2010-2014
<b>Nominal GDP (Billions of dollars)</b>					
September 2004	11,004	11,753	12,464	15,016 <sup>a</sup>	18,628 <sup>b</sup>
January 2004	10,980	11,629	12,243	14,686 <sup>a</sup>	18,266 <sup>b</sup>
<b>Nominal GDP (Percentage change)</b>					
September 2004	4.9	6.8	6.1	4.8	4.4
January 2004	4.8	5.9	5.3	4.7	4.5
<b>Real GDP (Percentage change)</b>					
September 2004	3.0	4.5	4.1	3.0	2.6
January 2004	3.2	4.8	4.2	2.8	2.5
<b>GDP Price Index (Percentage change)</b>					
September 2004	1.8	2.2	1.8	1.7	1.8
January 2004	1.6	1.1	1.1	1.8	1.9
<b>Consumer Price Index<sup>c</sup> (Percentage change)</b>					
September 2004	2.3	2.6	2.0	2.2	2.2
January 2004	2.3	1.6	1.7	2.2	2.2
<b>Unemployment Rate (Percent)</b>					
September 2004	6.0	5.6	5.2	5.2	5.2
January 2004	6.0	5.8	5.3	5.1	5.2
<b>Three-Month Treasury Bill Rate (Percent)</b>					
September 2004	1.0	1.3	2.6	4.5	4.6
January 2004	1.0	1.3	3.0	4.5	4.6
<b>Ten-Year Treasury Note Rate (Percent)</b>					
September 2004	4.0	4.6	5.4	5.5	5.5
January 2004	4.0	4.6	5.4	5.5	5.5
<b>Tax Bases (Billions of dollars)</b>					
Corporate book profits					
September 2004	874	1,045	1,455	1,411 <sup>a</sup>	1,710 <sup>b</sup>
January 2004	844	948	1,319	1,359 <sup>a</sup>	1,670 <sup>b</sup>
Wages and salaries					
September 2004	5,104	5,370	5,703	6,924 <sup>a</sup>	8,592 <sup>b</sup>
January 2004	5,087	5,333	5,639	6,823 <sup>a</sup>	8,476 <sup>b</sup>
<b>Tax Bases (Percentage of GDP)</b>					
Corporate book profits					
September 2004	7.9	8.9	11.7	10.0	9.1
January 2004	7.7	8.1	10.8	9.9	9.1
Wages and salaries					
September 2004	46.4	45.7	45.8	46.1	46.1
January 2004	46.3	45.9	46.1	46.4	46.4
<b>Memorandum:</b>					
Real Potential GDP (Percentage change)					
September 2004	3.2	3.1	3.1	3.0	2.6
January 2004	3.4	3.3	3.1	3.0	2.6

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. Level in 2009.

b. Level in 2014.

c. The consumer price index for all urban consumers.



# A

## A Comparison of CBO's and OMB's Baselines

**T**he Administration's Office of Management and Budget (OMB) published its annual *Mid-Session Review* of the President's budget on July 30, 2004. In that report, OMB updated its baseline budget projections and its economic assumptions through 2009. This appendix compares OMB's baseline projections (also referred to as its current-services baseline) with those of the Congressional Budget Office (CBO).

In the past, OMB and CBO constructed their baselines using similar concepts derived from the Balanced Budget and Emergency Deficit Control Act of 1985. Consequently, discrepancies between the agencies' estimates were attributable to differences between their respective technical or economic assumptions.

In its February 2004 baseline and subsequently in its *Mid-Session Review*, however, the Administration has deviated from prior practices in several ways. First, OMB's baseline assumes that major provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 will be extended, although under statutory baseline rules they should be assumed to expire as scheduled. Second, the Administration has not extended into future years the \$87 billion supplemental appropriation for 2004 enacted in November 2003 (mostly for military and reconstruction activities in Iraq and Afghanistan). Third, the Administration makes an adjustment in its baseline to the way it accounts for increases in pay when projecting discretionary spending.

In addition to those differences, CBO incorporates in its baseline the funding levels specified in the Department of Defense Appropriations Act, 2005—including both the regular 2005 appropriations for the Department of Defense and \$28 billion in 2004 supplemental funding, mostly for operations in Iraq and Afghanistan. OMB's *Mid-Session Review* was prepared before the enactment of that legislation and does not include it in its estimates.

For 2004, CBO anticipates a federal budget deficit of \$422 billion—\$22 billion less than OMB's baseline estimate of a \$444 billion deficit. For each of the following five years, CBO projects a higher deficit than OMB does. In total, CBO projects a deficit of nearly \$1.6 trillion for the 2005-2009 period, as compared with OMB's projection of a \$1.1 trillion deficit (see Table A-1). Almost all of the difference in the agencies' deficit projections falls on the spending side of the budget.

OMB's *Mid-Session Review* also references an alternative baseline projection that follows the procedures specified in the Deficit Control Act. (It labels that baseline its "BEA baseline," because many of the provisions in the Deficit Control Act that govern baseline projections were enacted as part of the Budget Enforcement Act of 1990.) Following the BEA rules makes OMB's BEA baseline conceptually consistent with CBO's baseline. Under its BEA baseline, OMB projects deficits totaling \$1.4 trillion over the 2005-2009 period, about \$170 billion less than CBO estimates—mostly because OMB's estimate does not reflect the defense appropriations that were enacted after it was prepared.

**Table A-1.****Comparison of CBO's September 2004 Baseline and OMB's July 2004 Current-Services Baseline**

(Billions of dollars)

	2004	2005	2006	2007	2008	2009	Total, 2005- 2009
<b>CBO's September 2004 Baseline</b>							
Revenues	1,871	2,094	2,279	2,406	2,531	2,673	11,983
On-budget	1,338	1,519	1,672	1,769	1,863	1,973	8,796
Off-budget	534	575	606	637	668	700	3,187
Outlays							
Discretionary	888	965	1,000	1,020	1,046	1,069	5,100
Mandatory	1,247	1,299	1,360	1,439	1,522	1,614	7,233
Net interest	159	178	217	255	281	302	1,234
Total	2,293	2,442	2,577	2,714	2,849	2,985	13,568
On-budget	1,912	2,039	2,164	2,288	2,409	2,527	11,427
Off-budget	381	403	413	426	441	458	2,140
<b>Surplus or Deficit (-)</b>	<b>-422</b>	<b>-348</b>	<b>-298</b>	<b>-308</b>	<b>-318</b>	<b>-312</b>	<b>-1,584</b>
On-budget	-574	-521	-491	-519	-546	-554	-2,631
Off-budget	153	173	193	211	228	242	1,047
<b>OMB's July 2004 Current-Services Baseline</b>							
Revenues	1,875	2,108	2,255	2,394	2,546	2,683	11,986
On-budget	1,342	1,530	1,649	1,754	1,872	1,975	8,780
Off-budget	534	578	606	640	674	708	3,206
Outlays							
Discretionary	902	910	888	898	916	934	4,545
Mandatory	1,258	1,309	1,390	1,473	1,570	1,666	7,409
Net interest	159	180	211	240	264	286	1,181
Total	2,319	2,400	2,489	2,611	2,749	2,886	13,135
On-budget	1,940	2,003	2,080	2,187	2,313	2,429	11,012
Off-budget	379	397	409	424	437	456	2,123
<b>Surplus or Deficit (-)</b>	<b>-444</b>	<b>-292</b>	<b>-234</b>	<b>-217</b>	<b>-204</b>	<b>-202</b>	<b>-1,149</b>
On-budget	-599	-473	-431	-434	-440	-454	-2,232
Off-budget	155	181	198	217	237	252	1,084

**Continued**

**Table A-1.****Continued**

	2004	2005	2006	2007	2008	2009	Total, 2005- 2009
<b>Difference (CBO's Baseline Minus OMB's)</b>							
Revenues	-4	-14	24	12	-15	-10	-3
On-budget	-4	-11	24	15	-9	-2	16
Off-budget	*	-2	*	-3	-5	-8	-19
Outlays							
Discretionary	-14	55	113	122	130	136	555
Mandatory	-11	-10	-30	-35	-48	-52	-176
Net interest	*	-2	6	16	17	16	53
Total	-26	42	88	103	100	99	433
On-budget	-28	37	83	101	96	98	415
Off-budget	2	6	5	3	4	1	18
Surplus or Deficit (-) <sup>a</sup>	22	-56	-64	-91	-114	-110	-436
On-budget	25	-48	-60	-86	-105	-100	-399
Off-budget	-2	-8	-4	-6	-9	-9	-36
<b>Memorandum:</b>							
Deficit Under the							
Administration's BEA Baseline	-444	-322	-282	-278	-273	-259	-1,413

Sources: Congressional Budget Office; Office of Management and Budget.

Note: \* = between -\$500 million and \$500 million; BEA = Budget Enforcement Act of 1990.

a. Positive numbers denote that the Administration's deficit estimate is higher than CBO's, and negative numbers denote that the Administration's deficit estimate is lower than CBO's.

## Outlays

CBO expects total outlays in 2004 to be \$26 billion lower than OMB does.<sup>1</sup> About \$14 billion of that difference is attributable to discretionary spending. (For defense, CBO's estimate is less than \$1 billion higher than OMB's; for nondefense, it is \$15 billion lower than OMB's.) For the 2005-2009 period, CBO projects \$433 billion more in total outlays than OMB does in its current-services baseline. Most of that difference is attrib-

utable to the differing approaches to projecting discretionary spending described above.

### Discretionary Spending

CBO estimates that discretionary outlays for defense in 2004 will total about \$452 billion—slightly higher than OMB's estimate. For the 2005-2009 period, CBO's projections for defense outlays exceed OMB's by \$471 billion. That difference results almost entirely from the fact that OMB does not extend and inflate the first \$65 billion in supplemental funding for defense in 2004 (which adds \$299 billion to CBO's baseline outlays for the five-year period) and does not include the effects of the 2005 defense appropriations act (including \$27 billion in sup-

1. OMB acknowledges in its 2005 *Mid-Session Review* that historically it has tended to overestimate outlays in its mid-session reports. Further, it states that "the tendency to overestimate outlays has been particularly noticeable in nondefense discretionary spending, where the overestimation has occurred every year for the past 10 years" (see page 4 of that report).

plemental funding for defense for 2004).<sup>2</sup> The appropriations for 2005 in that law add \$46 billion to CBO's baseline outlays over the 2005-2009 period, and the supplemental appropriations add \$125 billion in outlays.

For nondefense discretionary spending, CBO's 2004 estimate of \$436 billion is \$15 billion less than OMB's total for the year. CBO expects slower spending of appropriations than OMB does for several departments, including Transportation, Homeland Security, and Education. For the 2005-2009 period, CBO projects that nondefense discretionary outlays will exceed OMB's estimate by \$84 billion, a difference of 3.5 percent of such outlays over that period. Most of that difference is due to \$22 billion in 2004 supplemental funding primarily for reconstruction in Iraq (provided in P.L. 108-106) that CBO extends and inflates in its baseline but OMB does not.

### Mandatory Spending

For mandatory outlays in 2004, CBO's estimate is lower than OMB's by \$11 billion. About \$4 billion of that difference is due to differing estimates of Medicaid outlays. Most of the remaining gap stems from differences in estimates in several areas, including loan repayments to the Rural Utilities Service and outlays for the Commodity Credit Corporation, Supplemental Security Income, Food Stamps, crop insurance, international assistance programs, civil service retirement, Temporary Assistance for Needy Families, and housing programs.

CBO projects about \$176 billion less in mandatory outlays over the 2005-2009 period than OMB does, a difference of about 2.5 percent. Two-thirds of that difference is related to Medicare spending, which OMB projects will be \$119 billion higher than CBO does for the five-year period. That partly results from OMB's higher estimates of spending for the prescription drug benefit and Medicare Advantage programs. Differences in projections of Medicaid spending account for another one-quarter of the difference in mandatory spending.

### Net Interest

CBO's and OMB's estimates for net interest in 2004 are almost identical. But for the 2005-2009 period, because

2. The first \$65 billion in supplemental appropriations for defense was provided in the Emergency Supplemental Appropriations Act for Defense and for the Reconstruction of Iraq and Afghanistan, 2004 (Public Law 108-106), which provided a total of \$87 billion in funding.

CBO projects higher deficits than OMB does, it also estimates that net interest will exceed OMB's total for the period by \$53 billion.

### Revenues

CBO projects that revenues will be about \$4 billion below OMB's current-services estimate in 2004 and \$14 billion below in 2005. Over the 2005-2009 period, CBO's revenue estimates are \$3 billion lower than OMB's, a very small difference. The largest difference in any year is in 2006, when CBO's projection exceeds OMB's by \$24 billion, or about 1 percent of projected revenues in that year.

Although the two agencies' estimates of revenues through 2009 are very similar in total, there are a number of largely offsetting differences in assumptions about future legislation, the economic outlook, and technical factors. First, the Administration includes in its current-services estimates the effects of making permanent some major elements of the tax cuts enacted in 2001 and 2003, several provisions of which expire at the end of this calendar year. The Administration estimates that extending those provisions will reduce revenues by about \$11 billion in 2005 and \$134 billion over the 2005-2009 period. Therefore, CBO's revenue baseline exceeds OMB's current-services baseline by comparable amounts because, by law, CBO's baseline does not assume future enactment of legislation.

Second, CBO's economic and technical estimating assumptions cause its revenue projection to be below OMB's in each year. The two agencies' economic and technical assumptions affect their projections of revenues over the 2004-2006 period in ways that partially offset each other. CBO estimates higher nominal gross domestic product (GDP) and higher corporate profits than does the Administration, thereby increasing revenue projections. However, as a result of the lower effective tax rate applied to incomes in the agency's economic projections, CBO estimates lower revenues. Beyond 2006, CBO projects lower GDP and wage and salary disbursements than does the Administration and applies lower effective tax rates to taxable incomes. Both of those factors tend to reduce CBO's revenue projections relative to the Administration's. Overall, economic and technical factors reduce CBO's estimates relative to OMB's by \$4 billion in 2004, \$25 billion in 2005, and \$137 billion over the 2005-2009 period. That difference through 2009 amounts to about 1 percent of projected revenues.



# B

## The Treatment of Federal Receipts and Expenditures in the National Income and Product Accounts

**T**he fiscal transactions of the federal government are reported in two major sets of accounts that are conceptually quite different. The presentation generally discussed in the press and used by executive branch agencies and the Congress (and the one followed in the main text of this report) is the *Budget of the United States Government*, as reported by the Office of Management and Budget. It focuses on cash flows—revenues and outlays, or the collection of taxes and fees and the disbursement of cash for the various federal functions. The goal of the budget is to provide information to assist lawmakers in their policy deliberations, to control federal activities, and to help the Department of the Treasury manage its cash balances and determine its borrowing needs.

The national income and product accounts (NIPAs) also report the federal government's transactions, but with different goals. The NIPAs, which are produced by the Bureau of Economic Analysis (BEA) at the Department of Commerce, are intended to provide a comprehensive measure of current production and related income generated by the U.S. economy.<sup>1</sup> A well-known measure of current production in the NIPAs is gross domestic product, or GDP. The accounts, which are used extensively in macroeconomic analysis, divide the economy into four major sectors—business, household, government, and the rest of the world (the foreign sector), each with its own set of accounts.<sup>2</sup> The federal sector, which is the focus of

this appendix, is one component of the government sector (the state and local sector is the other component).<sup>3</sup> Because the goals of the NIPAs differ from those of the budget, the two accounting systems treat some government transactions very differently. The differences cause the receipts and expenditures in the NIPAs, as projected by the Congressional Budget Office (CBO), to exceed the corresponding budget totals by about 3 percent for the 2005–2014 period.

### Conceptual Differences Between the NIPAs' Federal Sector and the Federal Budget

The budget of the federal government is best understood as an information and management tool. It focuses mostly on cash flows, recording for each period the inflow of revenues and the outflow of spending.<sup>4</sup> The main period of interest in the budget accounts is the federal fiscal year, which runs from October 1 through September 30. There are a few exceptions to the general rule of recording transactions on a cash basis, but they are in-

1. The discussion of the NIPAs in this appendix generally refers to Table 3.2 in the accounts, "Federal Government Current Receipts and Expenditures," which most closely resembles the presentation in the budget. For other discussions of the NIPAs, see Bureau of Economic Analysis, "Federal Budget Estimates for Fiscal Year 2005," *Survey of Current Business* (March 2004); and *Budget of the United States Government, Fiscal Year 2005: Analytical Perspectives*.

2. Some accounts in the NIPAs, such as the domestic capital account (which shows saving and investment), focus on components of GDP or gross domestic income, rather than on a specific sector, and bring together relevant information from all four sectors.
3. More formally, BEA regards the federal government and the state and local governments as subsectors. The treatment of state and local governments' transactions in the NIPAs closely resembles that of the federal government.
4. Some budget accounts distinguish between on-budget and off-budget transactions and between federal funds and trust funds. Those distinctions do not affect the overall budget balance, have no economic implications, and do not appear in the NIPAs.

tended to improve the usefulness of the budget as a tool for making decisions. For example, when the federal government makes direct loans or provides loan guarantees (as with student loans), simply tracking flows of cash would give a misleading view of costs. So (under what is known as credit reform) the budget records the estimated subsidy costs at the time that the loans are made.

The federal sector of the NIPAs has none of the planning and management goals of the budget. Instead, it is focused on displaying how the federal government fits into a general framework that describes current production and income within specific periods and what happens to that production and income. The main periods of interest for the NIPAs are calendar years and calendar quarters, although approximate totals for fiscal years can be derived from the quarterly estimates.

From the point of view of the NIPAs, the federal government is both a producer and a consumer: its workforce produces government services, and its purchases consume some of the nation's production. In addition, the federal government affects the resources available to the private sector, through its taxes and transfers. The job of the NIPAs is to record all of those activities in a consistent manner.

The federal sector of the NIPAs tracks how much the government spends on consumption purchases, and it records the transfer of resources that occurs through taxes, payments to beneficiaries of federal programs, and federal interest payments. The federal sector's contribution to GDP is presented elsewhere in the NIPAs.<sup>5</sup>

5. As part of its comprehensive revisions to the NIPAs officially implemented in December 2003, BEA explicitly recognizes the services produced by the government as part of GDP and treats government purchases of goods and services (which are part of the business sector's contribution to GDP) as intermediate inputs to the production of government services. (Thus, the NIPAs now handle transactions in the government sector similarly to those in the business sector.) The changes shift the composition of GDP away from goods and toward services, because the government's purchases of goods are now classified as inputs to a new component of GDP, government services. Although that new treatment changes the relative importance of different components of GDP as reported in Table 1.1.5 in the accounts ("Gross Domestic Product and Income"), it does not change the level of GDP or the transactions reported in the NIPAs' federal sector (Table 3.2 in the accounts).

## Differences in Accounting for Major Transactions

The accounting differences between the NIPAs and the federal budget stem from the conceptual differences discussed above. In attempting to properly incorporate federal transactions into the framework used to determine GDP, the NIPAs reflect judgments about the best treatment of transactions such as government investment, sales and purchases of existing assets, federal credit, and activities that resemble those of businesses, along with transactions involving U.S. territories. In some cases, the appropriate treatment may be to exclude the transaction entirely from the NIPAs or to move it from the federal sector to another place in the NIPAs. In other cases, the appropriate treatment may involve recording as a receipt in the NIPAs something that the federal budget reports as an offsetting (negative) budget outlay, or adjusting the timing of a federal transaction to better match the timing of related production or income flows.<sup>6</sup>

## The Measurement of National Saving

Several conventions in the NIPAs are intended to portray the federal government's contribution to national saving. Two major departures from the budget are the treatment of federal investment spending (for such things as ships, computers, and office buildings) and the treatment of federal employees' retirement programs.

In the federal budget, outlays for investment purchases are treated like other cash outlays and thus are subtracted from budget revenues to determine the size of the federal deficit or surplus. In the NIPAs, by contrast, federal investment is not counted as federal spending for the purpose of measuring net federal saving (current receipts minus current expenditures).<sup>7</sup> That is because new purchases of federal capital (investments) do not measure the current inputs from the existing stock of capital used to provide government services. To approximate the cost of those capital inputs, the NIPAs include in current federal

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6. The resulting differences between the numbers in the NIPAs and the budget are sometimes divided into three groups: coverage, netting, and timing. While all three types of differences can affect total revenues or outlays, netting differences have no impact on the federal deficit or surplus because they affect revenues and outlays equally.
7. Federal investment is shown elsewhere in the government sector (Table 9.5.1 in the accounts) and is also counted along with private investment spending in the domestic capital account, which shows saving and investment (Table 5.1 in the accounts).

expenditures an estimate of the depreciation (consumption of fixed capital) of the stock of federal capital. This treatment is conceptually similar to that for the corporate business sector, which uses depreciation rather than investment purchases to compute net corporate saving (retained earnings). In the federal budget, depreciation is not tracked. In Table B-1, that difference in coverage by the NIPAs and the budget is shown under "Treatment of investment and depreciation."<sup>8</sup>

The transactions of federal employees' retirement programs are also handled very differently in the budget and the NIPAs. In the budget, federal employees' contributions to their retirement are recorded as revenues, whereas agencies' contributions on behalf of their employees (as well as interest payments from the Treasury to trust funds) have no overall budgetary effect because they are simply transfers of funds between two government accounts.<sup>9</sup> Benefit payments to retirees are recorded as outlays in the budget. By contrast, in the NIPAs, the aim is to make the measurement of saving by the federal government consistent with that by the private sector. Therefore, the NIPAs treat some of the transactions of federal retirement plans, except for the Railroad Retirement Fund, as part of the household sector.<sup>10</sup> The receipts from federal employers' and employees' retirement contributions (and the interest earned by retirement accounts) are considered part of the personal income of workers and thus are not recorded as federal transactions (receipts or negative expenditures). That parallels the treatment for the private sector.

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8. The estimates and presentation of the reconciliation between the NIPAs and the budget in Table B-1 are based on CBO's interpretation of the revised methodology for the accounts, as presented in Bureau of Economic Analysis, *Survey of Current Business* (June 2003), and on BEA's reconciliation of the Administration's budget for fiscal year 2005, published in the March 2004 *Survey of Current Business*.
9. In the budget, contributions by an agency for its employees' retirement are outlays for that agency and are offsetting receipts (negative outlays) for the trust funds. Thus, those intragovernmental transfers result in no net outlays or receipts for the total budget. That treatment is the same for Social Security and Medicare contributions by the federal government for its employees.
10. Social Security contributions and benefit payments for both private and government employees are kept in the federal sector as receipts and expenditures rather than moved to the household sector.

On the outlay side, pension benefit payments to retirees are not recorded as federal expenditures in the NIPAs because they are treated as transfers from pension funds within the household sector. Some transactions, however, are treated as part of federal expenditures even though the corresponding receipts are recorded in the household sector. The government's payments to its workers' retirement are counted as federal expenditures, as part of employee compensation, as is the interest paid to federal retirement accounts. The different treatment of retirement contributions by federal employees shows up in Table B-1 under "Receipts"; the different treatment of contributions by federal employers, interest earnings, and benefit payments is shown under "Expenditures."

### **Capital Transfers and Exchanges of Existing Assets**

The NIPAs measure current production and income rather than transactions involving existing assets. Thus, the NIPAs do not count capital transfers or asset exchanges as part of federal receipts or expenditures, although the budget generally does include those transactions. The NIPAs define as capital transfers, and thus exclude, estate and gift taxes (which are taxes on private capital transfers), investment subsidies to businesses, and investment grants to state and local governments (for highways, transit, air transportation, and water treatment plants).<sup>11</sup> Exchanges of existing assets include federal transactions for deposit insurance and sales and purchases of government assets (including assets that are not produced, such as land and the radio spectrum). In Table B-1, those differences between the NIPAs' federal sector and the budget accounts show up on the revenue side as estate and gift taxes and on the outlay side as capital transfers and lending and financial adjustments.

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11. Another type of capital transfer recognized by BEA in the NIPAs is the annual lump-sum payment from the Treasury to the Uniformed Services Retiree Health Care Fund—a trust fund begun in fiscal year 2003 to pay for benefits received by Medicare-eligible retired members of the armed forces and their dependents. Those payments to the trust funds are for accrued but unfunded liabilities for benefits attributable to work performed before 2003. BEA now excludes those payments from federal expenditures because they are not related to current production. Thus, those payments have no impact on net federal saving. In the budget, those annual payments are recorded as outlays by the Treasury but as offsetting receipts (negative outlays) by the trust fund. Because those annual payments have no net impact on federal spending in either the NIPAs or the budget, there is no corresponding reconciliation item in Table B-1.

**Table B-1.****Relationship of the Budget to the Federal Sector of the National Income and Product Accounts**

(Billions of dollars)

	Actual											
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Receipts</b>												
Revenues (Budget) <sup>a</sup>	1,782	1,871	2,094	2,279	2,406	2,531	2,673	2,821	3,077	3,308	3,471	3,648
Differences												
Coverage												
Contributions for government employees' retirement	-5	-4	-4	-4	-4	-4	-4	-3	-3	-3	-3	-3
Estate and gift taxes	-22	-24	-22	-26	-24	-26	-26	-19	-21	-40	-43	-48
Geographic adjustments	-4	-4	-4	-4	-4	-5	-5	-5	-5	-6	-6	-6
Universal Service Fund receipts	-6	-6	-6	-7	-7	-7	-7	-7	-7	-8	-8	-8
Subtotal, coverage	-36	-38	-37	-41	-39	-41	-41	-35	-37	-56	-59	-64
Timing shift of corporate estimated tax payments	6	*	-7	0	0	0	0	0	0	0	0	0
Netting												
Medicare premiums	28	32	37	55	64	68	74	80	88	96	105	115
Deposit insurance premiums	*	*	*	1	1	1	1	2	2	2	2	2
Government contributions for OASDI and HI for employees	13	14	15	15	16	17	18	20	21	22	23	25
Income receipts on assets	14	16	16	16	16	17	17	17	17	18	18	19
Surpluses of government enterprises	5	5	4	3	3	4	3	4	4	4	4	4
Other	20	22	23	21	22	22	22	22	23	23	23	24
Subtotal, netting	80	88	95	112	122	129	136	144	154	164	176	188
Other adjustments	30	14	2	-2	-2	3	-2	-3	*	-5	*	*
<b>Total Differences</b>	<b>81</b>	<b>64</b>	<b>53</b>	<b>69</b>	<b>81</b>	<b>91</b>	<b>93</b>	<b>106</b>	<b>117</b>	<b>103</b>	<b>117</b>	<b>123</b>
Receipts in the NIPAs	1,863	1,936	2,147	2,348	2,487	2,622	2,766	2,927	3,193	3,411	3,588	3,771
<b>Expenditures</b>												
Outlays (Budget) <sup>a</sup>	2,158	2,293	2,442	2,577	2,714	2,849	2,985	3,119	3,276	3,378	3,547	3,713
Differences												
Coverage												
Treatment of investment and depreciation	-8	-17	-20	-22	-24	-26	-28	-30	-33	-35	-38	-40
Contributions for government employees' retirement	32	34	37	37	37	38	38	39	40	41	43	44
Capital transfers	-41	-44	-47	-50	-51	-52	-53	-53	-54	-55	-56	-56
Lending and financial adjustments	20	16	16	21	20	20	13	13	12	13	13	13
Geographic adjustments	-13	-13	-13	-14	-14	-15	-15	-16	-17	-18	-18	-19
Universal Service Fund payments	-6	-6	-7	-6	-6	-6	-6	-7	-7	-7	-7	-7
Other	-15	-30	-16	-8	-5	-3	-2	*	2	4	6	8
Subtotal, coverage	-30	-59	-50	-41	-44	-45	-53	-53	-55	-57	-57	-58
Timing adjustments	2	-1	-10	4	10	0	0	0	-17	17	0	0

**Continued**

**Table B-1.****Continued**

	Actual											
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Netting</b>												
Medicare premiums	28	32	37	55	64	68	74	80	88	96	105	115
Deposit insurance premiums	*	*	*	1	1	1	1	2	2	2	2	2
Government contributions for												
OASDI and HI for employees	13	14	15	15	16	17	18	20	21	22	23	25
Income receipts on assets	14	16	16	16	16	17	17	17	17	18	18	19
Surpluses of government enterprises	5	5	4	3	3	4	3	4	4	4	4	4
Other	20	22	23	21	22	22	22	22	23	23	23	24
Subtotal, netting	80	88	95	112	122	129	136	144	154	164	176	188
<b>Total Differences</b>	<b>52</b>	<b>28</b>	<b>35</b>	<b>74</b>	<b>87</b>	<b>85</b>	<b>83</b>	<b>91</b>	<b>82</b>	<b>124</b>	<b>119</b>	<b>129</b>
Expenditures in the NIPAs	2,209	2,331	2,482	2,651	2,802	2,934	3,068	3,211	3,358	3,503	3,665	3,842
<b>Net Federal Government Saving</b>												
Budget Deficit (-) or Surplus <sup>a</sup>	-375	-422	-348	-298	-308	-318	-312	-298	-200	-70	-75	-65
<b>Differences</b>												
<b>Coverage</b>												
Treatment of investment and depreciation	8	17	20	22	24	26	28	30	33	35	38	40
Contributions for government employees' retirement	-37	-38	-41	-41	-41	-41	-42	-43	-43	-44	-46	-46
Estate and gift taxes	-22	-24	-22	-26	-24	-26	-26	-19	-21	-40	-43	-48
Capital transfers	41	44	47	50	51	52	53	53	54	55	56	56
Lending and financial adjustments	-20	-16	-16	-21	-20	-20	-13	-13	-12	-13	-13	-13
Geographic adjustments	9	9	9	9	9	10	10	11	12	12	13	13
Universal Service Fund	*	*	*	*	*	-1	-1	-1	-1	-1	-1	-1
Other	15	30	16	8	5	3	2	*	-2	-4	-6	-8
Subtotal, coverage	-6	21	12	*	5	4	11	18	19	1	-2	-6
Timing adjustments	4	1	3	-4	-10	0	0	0	17	-17	*	*
Other adjustments	30	14	2	-2	-2	3	-2	-3	*	-5	*	*
<b>Total Differences</b>	<b>29</b>	<b>36</b>	<b>18</b>	<b>-5</b>	<b>-7</b>	<b>6</b>	<b>10</b>	<b>14</b>	<b>35</b>	<b>-22</b>	<b>-2</b>	<b>-6</b>
Net Federal Government Saving	-346	-385	-330	-303	-315	-312	-302	-284	-165	-92	-77	-71

Source: Congressional Budget Office.

Notes: \* = between -\$500 million and \$500 million; OASDI = Old-Age, Survivors, and Disability Insurance; HI = Hospital Insurance.

a. Includes Social Security and the Postal Service.

### Credit Programs

The budget is not affected by all of the transactions associated with federal loans and loan guarantees—just the administrative costs and the estimated cost of subsidies. Loan disbursements, loan repayments, and interest are reported in what are termed financing accounts, which have no effect on revenues or outlays.

Like the budget, the NIPAs record administrative costs and generally exclude loan disbursements and repayments and other cash flows considered exchanges of existing assets or financial and lending transactions unrelated to current production. Unlike the budget, however, the NIPAs do not record subsidy costs. Also, unlike the budget, the NIPAs include the interest receipts from credit programs (as part of federal receipts). Those differences in the treatment of credit programs are recorded in two places. Under “Expenditures” in Table B-1, the lending and financial adjustments show the differences in handling the loan subsidies, and under “Receipts,” the difference in treating loan interest is captured as income receipts on assets.

### Geographic Coverage

The NIPAs exclude all government transactions with Puerto Rico and the U.S. territories, whose current production is, by the NIPAs’ definition, not part of U.S. GDP. Because federal transfers dominate those transactions, their exclusion tends to increase the NIPAs’ depiction of net federal saving, in comparison with the budget’s measure of saving—the federal deficit or surplus. That difference in coverage is shown as geographic adjustments in Table B-1.

### Universal Service Fund

The budget, but not the NIPAs’ federal sector, records the business activity of the Universal Service Fund, which provides resources to promote access to telecommunications. The fund receives federally required payments from providers of interstate and international telecommunications service and disburses those funds to local providers that serve high-cost areas, low-income households, libraries, and schools, as well as to rural health care providers. The fund is administered by an independent nonprofit corporation (the Universal Service Administrative Company), which is regulated by the Federal Communications Commission.

Because of the limited role played by the government, the fund’s receipts and payments are classified in the NIPAs

as intracorporate transfers (from one business to another) and are not recorded in the federal sector of the accounts. The fund’s revenues and outlays appear in the federal budget but have little net impact on the deficit or surplus. The difference in treatment of the Universal Service Fund is so labeled in Table B-1.

### Interest Receipts

In the NIPAs, federal interest receipts are grouped with other types of federal receipts (in the category called “income receipts on assets”) rather than netted against federal interest payments, as they are in the federal budget.<sup>12</sup> BEA’s treatment is consistent with international accounting practices, under which interest receipts and payments are reported separately. That difference between the NIPAs and the federal budget in their treatment of interest receipts raises the NIPAs’ measure of government receipts relative to federal budget revenues and increases the NIPAs’ measure of federal spending relative to budget outlays. However, because the difference in treatments affects receipts and expenditures in the NIPAs by exactly the same amount, it has no impact on the NIPAs’ measurement of net government saving.

### Surpluses of Government Enterprises

In the NIPAs, the surpluses of government enterprises, such as the Postal Service, are shown on a separate line under federal government current receipts. That treatment is in line with international accounting standards, which generally advocate reporting spending on a gross rather than a net basis. By contrast, surpluses of government enterprises are treated as offsetting receipts (negative outlays) in the federal budget.

### Military Sales and Assistance in Kind

The NIPAs attempt to identify contributions to GDP by sector. Therefore, they do not classify military purchases of equipment and services for sale and for gifts to foreign governments as part of federal consumption. Instead, those transactions are part of net exports in the NIPAs’ foreign transactions account (Table 4.1 in the accounts). In the case of gifts, the transactions are also recorded in the federal sector of the NIPAs as part of transfers to the rest of the world—a classification that parallels their treatment as outlays in the federal budget. By contrast with their treatment in the NIPAs, military purchases for

12. About half of interest receipts, mainly interest from penalties on late tax payments, are recorded as revenues in the federal budget.

sale to foreign governments are recorded in the federal budget as outlays, while the proceeds from those sales are recorded as offsetting receipts (negative outlays).

### Timing Differences

The NIPAs attempt to measure income flows as much as possible when income is earned (on an accrual basis) rather than when income is received (on a cash basis).<sup>13</sup> That approach makes sense in an integrated system of accounts that is tracking both production and income, because on an accrual basis the value of what is produced in a period should (measurement problems aside) match the total income generated. For example, BEA attributes corporate tax payments to the year in which the liabilities are incurred rather than to the time when the payments are actually made. However, the NIPAs are not entirely consistent in this respect: personal tax payments are counted as they are made and are not attributed back to the year the liabilities were incurred. Currently, BEA is engaged in research to develop methods for preparing accrual-based estimates of personal tax payments.

Because the budget is mostly on a cash basis and the NIPAs' federal sector is largely on an accrual basis, differences exist in a number of areas in the timing for recording transactions.

**Corporate Taxes.** Tax legislation sometimes temporarily shifts the timing of corporate tax payments (usually from the end of one fiscal year to the beginning of the next one). The NIPAs exclude such timing shifts, which are not consistent with accrual accounting. The timing adjustments for the effects of the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Reconciliation Act of 2003 are shown as the timing shift of corporate estimated tax payments in Table B-1.

Although corporations make estimated tax payments throughout the year, any shortfalls (or overpayments) are corrected in the form of final payments (or refunds) in subsequent years. The NIPAs shift those final payments back to the year in which the corporate profits that gave rise to the tax liabilities actually were generated, whereas

the budget records them on a cash basis. The results of that difference are difficult to identify for recent history and thus appear under "Other adjustments" under "Receipts" in Table B-1.<sup>14</sup>

**Personal Taxes.** Although personal taxes are not recorded on an accrual basis in the NIPAs, BEA nevertheless attempts to avoid large, distorting upward or downward spikes in personal disposable income due to timing quirks. Such quirks occur, for example, in April of each year, when most final settlements for the previous year's personal taxes are paid. In the NIPAs, therefore, those settlements are evenly spread over the four quarters of the calendar year in which they are paid. (As with accrual accounting, that treatment avoids spikes. Unlike accrual treatment, however, it does not move payments back to the year in which the liabilities were incurred.) The smoothing can alter the relationship of the NIPAs and the budget accounts for fiscal years because it shifts some receipts into the last quarter of the calendar year and thus into the following fiscal year. Those adjustments are difficult to identify for recent history and thus are not shown separately in Table B-1, but appear in the "Other adjustments" category under "Receipts."

**Transfers and Military Compensation.** Timing adjustments are needed on the spending side of the NIPAs to align military compensation and government transfer payments—for example, veterans' benefits, Supplemental Security Income (SSI) payments, and Medicare's payments to providers—with income that is reported on an accrual basis in the NIPAs. Misalignments can occur because of delays in payments or quirks in the calendar.

For example, by contrast with the federal budget, the NIPAs record Medicare payments on an accrual rather than on a cash basis. That treatment better shows the link between the underlying economic activity (the medical services provided) and the associated federal transactions (payment for those services), which can be several months apart. That timing adjustment, however, has only a small effect on the NIPAs' measure of net federal saving.

Although SSI payments are usually made on the first day of each month, the checks are sometimes mailed a day or

13. See United Nations, *System of National Accounts* (1993), paragraph 3.19, which emphasizes reporting transactions on an accrual basis. Many of the conceptual changes to the NIPAs over time have been based on the guidelines enumerated in that U.N. document.

14. "Other adjustments" include timing differences not shown elsewhere in Table B-1, plus discrepancies between figures in the NIPAs and the budget that may diminish when BEA makes subsequent revisions.

more in advance. That situation typically occurs when the first of the month falls on a weekend or holiday. If it occurs for the October payments, the payments will be pushed into the previous fiscal year in the budget. In such cases, the NIPAs introduce a timing adjustment that effectively puts the payments back on the first day of the month. Hence, the NIPAs' adjustment always ensures that there are exactly 12 monthly SSI payments in a year, whereas in the budget, there can be 11 in some years and 13 in others.

For military compensation, which is paid at the beginning and the middle of each month, the adjustment in the NIPAs always ensures 24 payments in the year. In the budget, by contrast, there can be 23 payments in some years and 25 in others. The timing adjustments for expenditures in Table B-1 reflect that regularizing for transfers and for military pay.

### Business Activities

The NIPAs and the federal budget both treat certain revenues as offsetting receipts (negative outlays) when they result from voluntary transactions with the public that resemble business activities, such as the proceeds from the sale of government publications. However, the NIPAs generally have a stricter view of what resembles a business transaction. In particular, Medicare premiums, deposit insurance premiums, rents, royalties, and regulatory or inspection fees are deemed equivalent to business transactions in the budget but not in the NIPAs. Consequently, those transactions (negative outlays in the budget) are treated in the NIPAs as government receipts (contributions for government social insurance and current transfers from business—fines and fees). Those differences are recorded under “Netting” in Table B-1. Because they affect total current receipts and total current expenditures by exactly the same amounts, they have no effect on the NIPAs' measure of federal saving.

### Presentation of the Federal Government's Receipts and Expenditures in the NIPAs

Like the budget, the federal sector of the NIPAs classifies receipts by type, but the categories differ (see Table B-2). The NIPAs' classifications help to determine measures of such things as disposable income and corporate profits after taxes. There are five major categories of current receipts. The largest one, current tax receipts, includes taxes on personal income, taxes on corporate income, taxes on production and imports, and taxes from the rest of the world. The next largest category is contributions for government social insurance, which consists of Social Security taxes, Medicare taxes and premiums, and unemployment insurance taxes. The remaining categories are current transfer receipts (fines and fees), income receipts on assets (interest, rents, and royalties), and current surpluses of government enterprises (such as the Postal Service). As discussed above, those surpluses, as well as interest and some other receipts, previously were recorded on the expenditure side of the NIPAs' federal sector as offsetting (negative) expenditures.

In the NIPAs, the government's expenditures are classified according to their purpose. The major groups, which are much fewer than those in the federal budget, are consumption expenditures, or purchases of goods and services (broken out for defense and nondefense purchases); transfer payments (to individuals, governments, and the rest of the world); interest payments; and subsidies to businesses and to government enterprises.

Defense and nondefense consumption of goods and services consists of purchases made by the government for its immediate use in production. (The largest portion of such consumption is the compensation of military and civilian federal employees.) Among the consumption expenditures, the consumption of fixed capital—depreciation—represents a partial measure of the services that the government receives from its stock of fixed assets, such as buildings or equipment.

**Table B-2.****Projections of Baseline Receipts and Expenditures as Measured by the National Income and Product Accounts**

(Billions of dollars)

	Actual											
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
<b>Receipts</b>												
Current Tax Receipts												
Personal current taxes	787	782	904	1,008	1,091	1,162	1,248	1,346	1,546	1,693	1,799	1,906
Taxes on corporate income	178	209	241	271	271	282	287	291	297	304	310	319
Taxes on production and imports	89	90	96	99	102	106	110	113	117	121	124	128
Taxes from the rest of the world	8	8	8	9	9	10	11	12	13	15	15	16
Subtotal	1,062	1,089	1,248	1,387	1,473	1,560	1,654	1,762	1,973	2,132	2,249	2,370
Contributions for Government												
Social Insurance <sup>a</sup>	750	792	842	904	955	1,000	1,048	1,099	1,152	1,207	1,265	1,324
Current Transfer Receipts	25	26	29	28	30	31	33	34	36	38	40	42
Income Receipts on Assets	22	23	25	25	26	27	27	28	29	30	30	31
Current Surpluses of Government Enterprises												
Current Receipts	5	5	4	3	3	4	3	4	4	4	4	4
	<b>1,863</b>	<b>1,936</b>	<b>2,147</b>	<b>2,348</b>	<b>2,487</b>	<b>2,622</b>	<b>2,766</b>	<b>2,927</b>	<b>3,193</b>	<b>3,411</b>	<b>3,588</b>	<b>3,771</b>
<b>Expenditures</b>												
Consumption Expenditures												
Defense												
Consumption	363	402	449	466	478	490	501	513	525	538	551	563
Consumption of fixed capital	61	62	63	63	64	65	65	66	67	68	69	69
Nondefense <sup>b</sup>												
Consumption	198	202	220	227	232	238	244	250	256	263	270	278
Consumption of fixed capital	23	25	25	26	26	27	27	27	28	28	29	29
Subtotal	646	691	757	782	800	818	837	857	876	897	918	939
Current Transfer Payments												
Government social benefits												
To persons	945	996	1,042	1,128	1,202	1,266	1,333	1,409	1,492	1,572	1,673	1,783
To the rest of the world	3	3	3	3	3	4	4	4	4	4	5	5
Subtotal	948	999	1,045	1,131	1,205	1,269	1,337	1,413	1,497	1,576	1,678	1,788
Other transfer payments												
Grants-in-aid to state and local governments <sup>b</sup>	330	349	360	369	383	401	422	446	473	501	532	565
To the rest of the world	23	23	31	38	40	41	42	43	44	45	46	46
Subtotal	353	372	392	407	423	442	464	489	517	546	577	612
Interest Payments <sup>b</sup>												
Subsidies	45	42	45	49	49	49	49	49	49	49	49	50
Current Expenditures	<b>2,209</b>	<b>2,321</b>	<b>2,477</b>	<b>2,651</b>	<b>2,802</b>	<b>2,934</b>	<b>3,068</b>	<b>3,211</b>	<b>3,358</b>	<b>3,503</b>	<b>3,665</b>	<b>3,842</b>
<b>Net Federal Government Saving</b>												
Net Federal Government Saving	<b>-345</b>	<b>-386</b>	<b>-330</b>	<b>-303</b>	<b>-315</b>	<b>-312</b>	<b>-302</b>	<b>-284</b>	<b>-165</b>	<b>-92</b>	<b>-77</b>	<b>-71</b>

Source: Congressional Budget Office.

a. Includes Social Security taxes, Medicare taxes and premiums, and unemployment insurance taxes.

b. Includes Social Security and the Postal Service.

Transfer payments (cash payments made directly to individuals and the rest of the world and grants to state and local governments or foreign nations) constitute another grouping. Most of the transfers to individuals are for social benefits.<sup>15</sup> Grants-in-aid are payments that the fed-

eral government makes to state or local governments, which generally use them for transfers (such as benefits provided by the Medicaid program) and consumption (such as the hiring of additional police officers). Grants-in-aid to foreigners include federal purchases of military equipment for delivery to foreign governments.

15. In its July 2004 data revisions, BEA published a revised estimate of government social benefits to individuals for 2003 that is significantly below its previously reported estimate, mainly because of downward revisions to its estimate of Medicare benefits (see "Annual Revision of the National Income and Product Accounts: Annual Estimates, 2001-2003, and Quarterly Estimates, 2001: I - 2004: I," *Survey of Current Business*, August 2004). Although CBO considers recent budget data more consistent with the higher estimate shown in the NIPAs before the July revisions, it has adopted BEA's estimate for 2003 in Tables B-1 and B-2. Over the next couple of years, CBO's forecast gradually removes BEA's recent adjustment to its overall figure for social benefits in 2003, which CBO estimates to be about \$11 billion, phasing it out fully by 2006.

The NIPAs' category for federal interest payments shows only payments and thus differs from the budget, which contains a category labeled "net interest." In the NIPAs, federal interest receipts are classified with other federal receipts.

The NIPAs' category labeled subsidies primarily consists of grants paid by the federal government to businesses, including state and local government enterprises such as public housing authorities. Federal housing and agricultural assistance have dominated that category.

## C

## CBO's Economic Projections for 2004 Through 2014

**Y**ear-by-year economic projections for 2004 through 2014 are shown in the accompanying tables (by calendar year in Table C-1 and by fiscal year in Table C-2). The Congressional Budget Office did not try to explicitly incorporate cyclical fluctuations into its projections for

years after 2005. Instead, the projected values shown in the tables for 2006 through 2014 reflect CBO's assessment of average values for that period—which take into account the potential ups and downs of the business cycle.

**Table C-1.****CBO's Year-by-Year Forecast and Projections for Calendar Years 2004 Through 2014**

	Actual 2003	Forecast		Projected								
		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Nominal GDP (Billions of dollars)	11,004	11,753	12,464	13,058	13,682	14,340	15,016	15,697	16,397	17,111	17,856	18,628
Nominal GDP (Percentage change)	4.9	6.8	6.1	4.8	4.8	4.8	4.7	4.5	4.5	4.4	4.4	4.3
Real GDP (Percentage change)	3.0	4.5	4.1	3.2	3.1	3.0	2.9	2.7	2.6	2.5	2.5	2.5
GDP Price Index (Percentage change)	1.8	2.2	1.8	1.5	1.6	1.7	1.8	1.8	1.8	1.8	1.8	1.8
Consumer Price Index <sup>a</sup> (Percentage change)	2.3	2.6	2.0	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index <sup>b</sup> (Percentage change)	2.9	2.5	3.1	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.0	5.6	5.2	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.0	1.3	2.6	4.0	4.6	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Ten-Year Treasury Note Rate (Percent)	4.0	4.6	5.4	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Tax Bases (Billions of dollars)												
Corporate book profits	874	1,045	1,455	1,430	1,384	1,390	1,411	1,447	1,495	1,552	1,621	1,710
Wages and salaries	5,104	5,370	5,703	6,003	6,303	6,611	6,924	7,238	7,560	7,891	8,235	8,592
Tax Bases (Percentage of GDP)												
Corporate book profits	7.9	8.9	11.7	11.0	10.1	9.7	9.4	9.2	9.1	9.1	9.1	9.2
Wages and salaries	46.4	45.7	45.8	46.0	46.1	46.1	46.1	46.1	46.1	46.1	46.1	46.1

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. The consumer price index for all urban consumers.

b. The employment cost index for wages and salaries only, private-industry workers.

**Table C-2.**
**CBO's Year-by-Year Forecast and Projections for Fiscal Years  
2004 Through 2014**

	Actual 2003	Forecast		Projected								
		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Nominal GDP (Billions of dollars)	10,841	11,559	12,304	12,909	13,522	14,173	14,846	15,526	16,220	16,931	17,667	18,433
Nominal GDP (Percentage change)	4.3	6.6	6.4	4.9	4.7	4.8	4.8	4.6	4.5	4.4	4.3	4.3
Real GDP (Percentage change)	2.5	4.6	4.3	3.3	3.1	3.0	2.9	2.7	2.6	2.6	2.5	2.5
GDP Price Index (Percentage change)	1.8	2.0	2.0	1.6	1.6	1.7	1.8	1.8	1.8	1.8	1.8	1.8
Consumer Price Index <sup>a</sup> (Percentage change)	2.4	2.3	2.3	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Employment Cost Index <sup>b</sup> (Percentage change)	2.8	2.6	2.9	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.0	5.7	5.4	5.1	5.1	5.2	5.2	5.2	5.2	5.2	5.2	5.2
Three-Month Treasury Bill Rate (Percent)	1.1	1.1	2.3	3.7	4.5	4.6	4.6	4.6	4.6	4.6	4.6	4.6
Ten-Year Treasury Note Rate (Percent)	3.9	4.4	5.3	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Tax Bases (Billions of dollars)												
Corporate book profits	837	1,005	1,369	1,443	1,390	1,386	1,405	1,438	1,483	1,537	1,602	1,682
Wages and salaries	5,053	5,294	5,622	5,929	6,226	6,533	6,845	7,159	7,479	7,807	8,148	8,502
Tax Bases (Percentage of GDP)												
Corporate book profits	7.7	8.7	11.1	11.2	10.3	9.8	9.5	9.3	9.1	9.1	9.1	9.1
Wages and salaries	46.6	45.8	45.7	45.9	46.0	46.1	46.1	46.1	46.1	46.1	46.1	46.1

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. The consumer price index for all urban consumers.

b. The employment cost index for wages and salaries only, private-industry workers.



# D

## Contributors to the Revenue and Spending Projections

### T

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Kenneth Farris	Computer support
Mary Froehlich	Computer support
Ann Futrell	Other interest, baseline coordination and report writing
Ellen Hays	Federal pay, baseline coordination and report writing
Catherine Little	Appropriation bills (VA-HUD, Transportation-Treasury)
Virginia Myers	Appropriation bills (Commerce-Justice-State, foreign operations)
Eric Schatten	Interest on the public debt, baseline coordination and report writing
Robert Sempsey	Appropriation bills (Labor-HHS, Homeland Security, military construction)
Gerard Trimarco	Other interest, baseline coordination and report writing
Patrice Watson	Computer support
Jason Wheelock	Appropriation bills (Defense, energy and water)